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Important Tax Changes Effected by the Internal Revenue Code of 1954

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Depreciation

BY MICHAEL OCHIS
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The 1954 Code allows the taxpayer greater discretion as to the timing of the depreciation deduction within the period of useful life; it does not allow the taxpayer more discretion in determining the period over which the property is to be written off. The new Code makes no change in the importance of useful life as the basis of depreciation rates; nor in the methods of determining useful life. The greater discretion in timing the depreciation deductions is accomplished by allowing the taxpayer:

1. To use any depreciation method previously allowed, as long as it results in a reasonable allowance for depreciation under section 167(a); or

2. To elect, for eligible property, any of the following depreciation methods under section 167(b):

(a) Declining-balance method using a rate not exceeding twice the straight-line rate;

(b) Sum-of-the-years-digits method;

(c) Any other consistent method which during the first two-thirds of the useful life of the property does not result in cumulative allowances at the end of any year greater than would have been accumulated had the declining-balance method been used.

DECLINING-BALANCE METHOD

Section 167(b)(2) allows the declining-balance method, at a rate not exceeding twice the straight-line rate, to be used on eligible property for years ending after 1953. The Report of the Senate Finance Committee (page 201) on the 1954 Code states that if the declining-balance method, limited to 150 per cent of the straight-line rate, allowable under the 1939 Code has been used for property acquired prior to 1954 it may continue to be used but the liberalized declining-balance method of the 1954 Code may not be used for such property. Salvage is not deducted from the basis under this method.

THE SUM-OF-THE-YEARS-DIGITS METHOD

Under this method, allowed by section 167(b)(3), the annual allowance is computed by applying a changing fraction to the asset cost of the property reduced by the estimated salvage value. The rate for any year is a fraction, the denominator of which is the sum of the digits representing the years of estimated life, and the numerator of

which is the remaining life at the beginning of each year. Thus, if the useful life is 10 years, the denominator of the fraction for each year is 55 (1 through 10, inclusive), the numerator for the first year's fraction would be 10 (the years of remaining life), for the second year 9, etc. This method results in full deduction of the cost, less salvage, by the end of the estimated life. The cost must be reduced by the estimated salvage before computing depreciation.

Sum-of-the-Years-Digits Method on Group, Classified, or Composite Accounts. The proposed depreciation regulations do not illustrate the application of this method to group, classified, or composite accounts. Since the use of this method for these accounts is allowed by the Code, the taxpayer must justify the method of computation used, and the reasonableness of the results without help from the regulations. However, pending clarification of this problem, it appears advisable to compute annual depreciation deductions by applying the sum-of-the-years-digits method to the total of the acquisitions for each year without reduction for retirements. Adjustment, if any, required upon review of the tax returns will depend upon the character and relationship of the components (the mix) of the account, its determinable or probable mortality characteristics and type of survivor curve, etc. Extensive research into the technical aspects of this problem is already under way by experienced members of the New York Office Tax Department and will be extended as future developments dictate.

Other Consistent Methods

Under section 167(b)(4), any consistent depreciation method may be used, but during the first two-thirds of the useful life of the property such method must not result in cumulative depreciation allowances at the end of any year greater than would have been accumulated had the declining-balance method been used. (The sum-of-the-years-digits method is specifically an exception to this rule.) This provision enables other methods to be used, such as a different depreciation rate for each year of life; or the multiple-straight-line method, which is a combination of different straight-line rates at different stages of service life; or, the unit-of-production or machine-hour method when such method is not reasonable under the general rule of "reasonable allowance" under section 167(a); etc. This limitation does not apply to a unit-of-production method that is reasonable under section 167(a).

Salvage

The proposed depreciation regulations, and the reports of the Congressional Committees, make it clear that in using any depreciation

method, except the declining-balance method, the salvage is to be deducted from the cost or other basis of depreciable property. It is not to be deducted under the declining-balance method, since the undepreciated balance remaining at the end of the useful life in this method is presumed to represent salvage. The salvage adjustment can also be made by a reduction in the depreciation rate to be applied to the basis, instead of reducing the basis by the salvage. This is the method generally used by engineer revenue agents. It is probable that examining agents will pay more attention to salvage in future examinations. The proper salvage amount is the probable salvage, less costs of dismantling, removal, etc., expected to be realized *at the time of disposal* of the property. The salvage adjustment can be recognized or made by the Treasury at any time. (See particularly the Tax Court's reasoning in the opinions in *Wier Long Leaf Lumber Co.*, 9 T. C. 990, aff'd and rev'd in part on other issues, 173 F. (2d) 549; *Anne P. Humphrey, et al*, T. C. Memo., Jan. 18, 1946; *W. H. Norris Lumber Co., Inc.*, T. C. Memo., Oct. 12, 1948.)

Declining-Balance Method v. Sum-of-the-Years-Digits Method

Because of the importance of the salvage factor in the results, it would seem that the sum-of-the-years-digits method should be used where the property will realize little or no salvage. Where the salvage ratio is significant (appreciably above 10 per cent for item accounts, and at somewhat lower levels for group, classified or composite accounts) the declining-balance method appears preferable. Taxpayers with a history of property retirement should determine their own salvage ratios and not assume that the ratios are insignificant. The Treasury will utilize the data from the taxpayer's own history in its determination of ratios.

Property Eligible for Accelerated Depreciation Methods (*Section 167*(*c*).)

The new accelerated depreciation methods authorized by the 1954 Code apply only to tangible property with a useful life of 3 or more years. They apply only (a) to property acquired after December 31, 1953, the first use of which begins with the taxpayer and begins after that date; or, (b) to that portion of the basis of property which is properly attributable to construction, reconstruction or erection after 1953. Notice that the word is "attributable" and not spent or incurred. The methods do not apply to property previously subject to depreciation. The purchase price of a used building or machine acquired after 1953 cannot be depreciated by these methods; but any capitalized additions or reconstruction thereof

after acquisition can be so depreciated.

Election of Depreciation Method

To elect to use any one of the new accelerated depreciation methods, the taxpayer need only compute depreciation on the eligible property for the taxable year ending after 1953 in which the property may first be depreciated by him. The election with respect to any property shall *not* be binding with respect to any property acquired in a subsequent taxable year.

In case of item accounts, any reasonable method may be used for each item of property but it must be applied consistently to that item. In the case of group, classified, or composite accounts, any reasonable method may be selected for each year's total acquisitions for any account, but the method so elected must be applied consistently to the particular year's acquisitions. However, the taxpayer may change at any time from the declining-balance method of section 167(b)(2) to the straight-line method.

The proposed regulations provide that if a taxpayer has filed his return for a taxable year ending after 1953 for which the return is required to be filed before January 1, 1956, the election to compute the depreciation allowance under the new methods may be made in an amended return filed before January 1, 1956. However, where returns have not been filed, it is advisable to procure an extension of time so that the proper elections may be made in the returns as filed, and not rely on amendment, since the words "has filed" might be narrowly construed to preclude amendment of returns filed after the issuance of the regulations.

Taxpayers That Begin Depreciation with Year Following Acquisition of Property. Some taxpayers begin depreciation with the first day of the year following the year of acquisition of the property, although, sometimes depreciation is begun on some assets in the year acquired. To guard against a narrow technical application of the words "taxable year ending after 1953 in which the property may first be depreciated by him," it is advisable that depreciation under any of the new methods be deducted in the year in which the eligible property is acquired, irrespective of how depreciation is computed on the taxpayer's other property.

Change in Method

With one exception, all changes in depreciation methods are changes in accounting methods under section 446(e) and, therefore, will require the consent of the Treasury (section 167(e)). However, unless there is a provision to the contrary contained in an agreement between the Treasury and the taxpayer (see below), a taxpayer may at any time elect, in accordance with regulations,

to change from the declining-balance method allowed by section 167(b)(2) of the 1954 Code to the straight-line method for any property.

Change from Declining-Balance Method. At the time of change-over from the declining-balance method to the straight-line method, the unrecovered basis, less a realistic salvage, shall be recovered over the estimated remaining useful life determined in accordance with the circumstances existing at that time. These two requirements are important. A statement, setting forth the information required by the regulations, shall be attached to the tax return for the taxable year in which the change is made. The straight-line method must be adhered to, beginning with the taxable year of change, unless the Treasury consents to a change to another method. The taxpayer may elect to change from the declining-balance method with respect to any item account. For other accounts, the change-over can only be made by each year of acquisition, provided subsidiary depreciation records are maintained for each acquisition year.

Method of Computing Depreciation Allowance by an Acquiring Corporation

In a tax-free complete liquidation of an 80 per cent or more owned subsidiary or in certain tax-free reorganizations, the acquiring corporation shall be treated, under section 381(c)(6), as the distributor or transferor corporation for purposes of computing the declining-balance, sum-of-the-years-digits, or "other consistent" methods of depreciation under section 167(b)(2), (3) and (4) of property taken over, but only to the extent of the basis carried over.

Allowed or Allowable Depreciation

The proposed regulations state that the rule "of not permitting a taxpayer to take advantage in later years of his action in deducting inadequate or no depreciation in prior years" is applicable regardless of the method of depreciation used by the taxpayer. The Code, under section 1016(a)(2) provides that where no method of computing depreciation has been adopted under section 167, the amount allowable shall be computed by the straight-line method.

Losses on Retirements

The proposed regulations continue the Treasury position that if depreciation is computed on more than one item and the rates are based on the average lives of the assets, losses are not allowable on the normal retirement of such assets. A special rule has been added in connection with the declining-balance method.

Unrecovered Basis under Declining-Balance Method. The use of the declining-balance method results in an unrecovered basis at the end of the estimated life, unless offset by salvage. For group, classified, or

composite accounts, if the taxpayer maintains records of depreciable assets by year of acquisition, the entire unrecovered cost of the year's acquisitions may be deducted as depreciation at the time of retirement of the last surviving unit.

Agreement as to Useful Life on Which Depreciation Is Based

Under section 167(d), a taxpayer and the Treasury may enter into a written agreement binding on both with respect to the useful life and rate of depreciation of any property. Thereafter, the party initiating a modification must establish the existence of facts and circumstances not taken into consideration in the adoption of such agreement. Any change in the agreed rate and useful life shall only be effective beginning with the taxable year in which written notice by registered mail is served by the party initiating the change.

It is doubtful if the Treasury will enter into any such agreement without first reviewing the useful life of the property to be covered for the taxable year and all open years. A taxpayer requesting such an agreement should be certain that the review will not result in a lengthening of the useful life over which the property is currently being depreciated. If this is not certain, it would seem to be inadvisable to request an agreement except in connection with an unsolicited review.

The primary value of an agreement is that any change in the useful life established in the agreement cannot be applied retroactively to open tax years but only prospectively. However, it would seem that the disclosure by the passage of time of a useful life materially different from that covered by the agreement would probably constitute facts not taken into consideration in the adoption of the agreement.

Records Which Must Be Kept

Where the new depreciation methods provided by the 1954 Code are used, separate asset and depreciation records must be maintained for property so depreciated. Except for property being depreciated in item accounts, a taxpayer who uses the declining-balance method must maintain subsidiary depreciation records by year of acquisition for group, classified, or composite accounts in order to have sufficient information to determine (1) the year in which the last survivor of a given year's acquisitions is retired, and (2) the unrecovered cost of that year's acquisitions. These detailed records are also required in order to have sufficient information to change from the declining-balance depreciation method to the straight-line method for a year's acquisitions.

Similar detailed records are necessary in order to apply the sum-of-the-years-digits method.

Certain Tax Changes of Importance to Corporations

By Julian O. Phelps
(Chicago Office)

This article is a brief digest of some of the more important provisions of the 1954 Code relating to corporations generally, which are not covered in the other articles herein on specific topics.

The following subjects are included:

	Sections
Rates and effective dates	11, 7851
Declarations of estimated tax	6016, 6655
Consolidated returns	1501-5, 1552
Net operating loss deduction	172
Corporations improperly accumulating surplus	531-537
Personal holding companies	541-547
Acquisition of loss corporations	269
Disallowance of multiple credits	1551

The discussion is confined to general principles, without attempting to cover in detail all rules and technicalities.

Rates and Effective Dates

Effective April 1, 1955, the 1954 Code promises a reduction in the corporate tax rate from 52 percent to 47 percent on income above $25,000, and from 30 percent to 25 percent on the first $25,000. This is the reduction which the 1951 Act had scheduled for April 1, 1954. Provision is made for proration in the case of 1955 calendar year returns and other returns which span the date of change. The alternate rate on capital gains will continue at 26 percent for calendar year 1954 returns. It will be reduced to 25 percent for taxable years beginning April 1, 1954 and later.

Except where otherwise specified, the 1954 Code applies to taxable years beginning after 1953 and ending after the date of enactment, August 16, 1954. Under this general rule it would not apply to a return filed for the six months ended June 30, 1954 because of a change of fiscal year.

There are many exceptions to the general rule. Among the exceptions affecting corporations are the following:

(1) The new methods of computing depreciation applicable to acquisitions made at any time after 1953.

(2) The provisions relating to reorganizations, liquidations, etc., apply to transactions taking place on or after June 22, 1954.

(3) Various procedural changes take effect on August 17, 1954, the day after enactment.

(4) The extension of the net operating loss carry-back from one year to two years makes possible a carry-back from 1954 to 1952.

Declarations of Estimated Tax

Beginning with the calendar year 1955, the larger corporations will be required to make advance payments of tax on September 15 and December 15. (The months mentioned herein are for calendar year returns. For fiscal year returns, the comparable months should be substituted.)

The acceleration of corporation tax installments which was initiated by the Revenue Act of 1950 will be completed with the payment of 1954 taxes. One-half of the 1954 corporation tax will be due on March 15, 1955 and the other half on June 15, 1955. According to the report of the Senate Finance Committee, corporation taxes account for 30 percent of the government's income, and the concentration of payments in the first half of the year "aggravates the effect of Treasury operations on the money markets" and "increases the problems of managing the public debt." This concentration also "makes it more difficult for corporations to manage their own financing." A system of advance payments is offered as a remedy for these conditions.

The new procedure will apply only where the tax is over $100,000. It will affect only about 20,000 out of 425,000 corporations, but these 20,000 corporations pay about 85 percent of the total corporate income tax.

In 1955 the September and December installments will each be 5 percent of the "estimated tax," leaving 45 percent to be paid on March 15 and again on June 15 of 1956. In 1956 the two advance payments will each be 10 percent and will increase 5 percent each year until they reach 25 percent in 1959.

The "estimated tax" is the estimated liability for the current year reduced by $100,000 and by the foreign tax credit. A declaration of estimated tax must be filed by every corporation whose income tax (minus credits) "can reasonably be expected" to exceed $100,000. The declaration is to be filed by September 15 (for calendar-year companies). If the requirement for filing is not met by August 31 and is met by December 1, the declaration should be filed by December 15 and both installments paid at that time. Provision is made for amended declarations.

The effect of the advance payment procedure, combined with the change made in 1950, will be to decrease over a ten-year period the working capital of large corporations by an amount approaching one-half of one year's income tax. A system of advance payments by corporations has been in effect in Canada for a number of years.

Penalties for Underestimate: "To facilitate compliance with these provisions," as the Committee reports express it, there will be an addition to the tax at the rate of 6 percent per annum on underpay-

ments of the advance installments. The amount of the underpayment is determined by using 70 percent of the tax shown on the return as the estimated tax. The period of underpayment runs from the due date of the installment to the following March 15, or to the date on which the underpayment is paid, whichever is earlier. For example, a 1955 tax return shows $1,000,000 tax liability, advance payments of $25,000 each are made on September 15 and December 15, 1955, and no additional payments are made before March 15, 1956. Each advance payment is underpaid by $10,000 (5% × 70% × $1,000,000 = $35,000; $35,000 — $25,000 = $10,000). The addition to the tax will be $450 (3% on the September 15 underpayment = $300; 1½% on the December 15 underpayment = $150). The addition to the tax is in the nature of a penalty and is not deductible as interest.

The penalty will not be imposed if the advance payments are based on an estimated tax which is as much as the least of the following:

(1) The tax on the preceding year's return, minus $100,000.

(2) A tax computed at current year rates on the income shown on the preceding year's return, with preceding year's law applied.

(3) 70 percent of the current year's tax, computed for the September 15 installment by annualizing the income for either the first six or the first eight months; and for the December 15 installment by annualizing the income for either the first nine or first eleven months. This provision will help where the bulk of the income is earned in the latter part of the year.

Consolidated Returns

The ownership test for inclusion of an affiliated company in a consolidated return is reduced by the 1954 Code from 95 percent to 80 percent. An affiliate will now be includible if other members of the group own at least 80 percent of its stock having voting power, and at least 80 percent of each class of nonvoting stock other than nonvoting preferred stock which is limited as to dividends. Where desired, an affiliate can be excluded by reducing ownership of its stock below 80 percent, but its income will have to be included up to the day the reduction is accomplished.

The two percent penalty tax for filing consolidated returns is dropped for such regulated companies as public utilities, telephone companies and common carriers. These industries are in a different position from others, in that problems of regulation may require incorporation in more than one state. Also, since their earnings are usually regulated with regard to the return on invested capital, any tax is theoretically passed to the consumer.

Allocation of Tax: The 1954 Code provides rules for the allocation of the consolidated tax among the various companies in the group. This allocation is important be-

cause it affects the earned surplus of each company, and consequently the taxability of dividends. It might also affect the $60,000 credit allowed under the new version of section 102, and it has various other applications. The methods of allocation permitted are as follows:

(1) In the ratio of the portion of the consolidated income attributable to each company (official sanction had previously been given to this method).

(2) In the ratio of the taxes which would be payable on separate returns.

(3) (a) Allocation, except for tax increase arising from consolidation, in the ratio of the contribution of each member to the consolidated income; (b) tax increase due to consolidation to be distributed in the ratio of the tax reduction of each member determined by comparing its tax under (a) with its tax on a separate return basis.

(4) Any other method subject to approval by the Internal Revenue Service.

The Commissioner of Internal Revenue has announced that a new election for the filing of separate returns will be granted to any group for the first return the due date of which, including extensions, is after August 16, 1954, or for its return for the first year ending after August 16, 1954.

Net Operating Loss Deduction

The most important new features introduced into the net operating loss deduction in the 1954 Code are:

(1) Under a general abandonment of the principle that benefits given under other provisions must be taken away when a net operating loss deduction is allowed, it will no longer be necessary to adjust taxable income to so-called "economic" income. Any benefit which the corporation might have from the 85 percent dividend deduction, fully tax-exempt interest (but not partially exempt interest) and the excess of percentage depletion over cost depletion will not be disturbed, either as to the year in which the loss arises, or as to years to which the loss is applied. These benefits would have been lost under the 1939 Code.

(2) A two-year carry-back of net operating loss as against one year under the 1939 Code. The five-year carry-over is not changed.

The difference in treatment of tax benefits will sometimes transform what would have been taxable income under the 1939 Code into a net operating loss under the 1954 Code. This is shown by the effect of dividends received in the following example:

	1954 Code	*1939 Code*
Operating loss.......	($20,000)	($20,000)
Dividends received...	50,000	50,000
1954 Code:		
Deduction, 85% of dividends received	(42,500)	
1939 Code:		
Credit, limited to 85% of $30,000 net income.......		(25,500)
1954 Code:		
Net operating loss.	$12,500	
1939 Code:		
Normal-tax net income............		$ 4,500

The interworking of the rules relating to net operating loss and to

the 85 percent deduction for dividends received sometimes leads to an unusual result which probably was not foreseen in the legislative process. The dividend deduction is limited to 85 percent of net income except where there is a net operating loss. In the following example, due to the limitation and the exception, an increase of one dollar in the operating loss eliminates $12,750 of taxable income:

Operating loss.......	($15,000)	($15,001)
Dividends received...	100,000	100,000
Deduct, 85% of dividends received:		
Limited to 85% of $85,000 net income under the general rule.....	(72,250)	
Unlimited where there is a net operating loss......		(85,000)
Taxable income......	$12,750	
Net operating loss....		$1

Transitional Rules: The full effect of the new rules will not become immediately available in the following cases:

(1) Although any net operating losses carried back from 1954 and 1955 will be computed under the 1954 Code, net operating loss deductions for 1952 and 1953 will be computed in other respects under the 1939 Code. Excess profits tax computations are not affected by the 1954 Code changes.

(2) Carry-overs from 1953 and earlier to years ending after 1953 will be determined under the 1939 Code.

(3) A special rule applies to fiscal years spanning December 31, 1953. The net operating loss carried back from a fiscal year ended April 30, 1954, for example, is the sum of (a) one-third of the net operating loss computed under the 1954 Code plus (b) two-thirds of the amount under the 1939 Code. Only one-third of the resulting sum can be carried back two years but the unused portion can be carried back one year and ahead five years. (The actual computations give effect to the exact number of days in the fiscal year which fall in 1953 and 1954, respectively.)

An unfortunate result of rule (3) is that the carry-back from the fiscal year ended April 30, 1954 might be reduced by the dividends received credit in each of the two preceding years. On the other hand, a carry-back under similar circumstances except that it comes from the calendar year 1954 might be reduced only by the dividend received credit in 1952.

Corporations Improperly Accumulating Surplus

The spectre which has haunted so many corporate taxpayers, the old surtax under section 102, has taken a new name—henceforth it will be the "accumulated earnings tax." It has also undergone a change in personality which should make it almost a pleasant individual to meet, that is, by comparison with past years.

The Congressional Committees were very critical of the administration of section 102. They found that it was a constant threat to expansion and that it was particularly harsh on smaller corporations which were poorly equipped to de-

fend themselves. There were complaints that it was being used as a club to force acceptance of deficiencies relating to other issues. In deciding whether to retain or distribute profits, the determination of the needs of the business would normally be made initially by management employing its skill and experience. Unfortunately, the determination would also be subject to the unpredictable judgment of a revenue agent who had no first-hand knowledge of those needs. To correct these conditions, a number of important changes were incorporated into the 1954 Code.

The following example shows the effect of the principal changes in computation, as applied to a 1954 calendar year return of a corporation:

1954 taxable income......		$200,000
Income tax.............		98,500
1954 earnings...........		101,500
Dividends paid:		
In 1954 after March 15.....	$20,000	
In February, 1955.........	12,000	32,000
1954 earnings retained....		69,500
Accumulated earnings credit:		
1954 earnings determined to be retained for reasonable needs of business..........	30,000(A)	
Accumulated earnings at December 31,1953	20,000(B)	
Minimum credit, $60,000 minus (B)..........	40,000(C)	
Credit, greater of (C) or (A)............		40,000
Accumulated taxable income................		$ 29,500(D)
Accumulated earnings tax, 27½ percent of (D) (rate would be 38½ percent on excess of (D) over $100,000)..............		$ 8,112.50

The example illustrates the following changes made by the 1954 Code:

(1) In computing the undistributed earnings tax, a credit is allowed that part of the year's earnings which is determined to be retained for reasonable needs of the business ($30,000 in the example). Under the old law, if any part of the accumulation was unreasonable, the entire accumulation of $69,500 would have been taxed. Accumulations in prior years must be taken into account in determining reasonable needs.

(2) A minimum accumulation of $60,000 is allowed before the tax is imposed. Since only $20,000 was accumulated at December 31, 1953, the credit in 1954 will be $40,000, instead of the $30,000 credit in (1). Small companies are thus freed from concern until their earned surplus reaches $60,000. There is to be no inference that an accumulation in excess of $60,000 is unreasonable.

(3) The dividends for which credit is allowed are the dividends paid in the twelve-month period ending on March 15 after the end of the year. This enables the management to have available the completed financial statements when the final dividend is being considered. Under the 1939 Code, dividends were not counted unless paid within the year and frequently only rough information was available when the amount of the final dividend was being determined.

A mere holding or investment company is allowed only the $60,000 minimum credit, with no consideration for what might be the reasonable needs of the business.

The 1954 Code specifically provides that the term "reasonable needs" includes "reasonably anticipated" needs, to counteract an immediacy test which has sometimes been applied. According to the Committee reports, there should be specific and definite plans for use of the funds, but an immediate need for the funds is not required. Furthermore, only the facts which are present at the close of the year are to be considered. The reports create some confusion by adding that intentions are to be examined in the light of subsequent events, and indefinite postponement of execution may nullify the fact that plans had been made. Presumably, in appropriate cases, any undesirable inference drawn from the subsequent events can be overcome by a showing of reasons for the change in plans.

There may be a worthwhile byproduct in the Committee's emphasis on definite plans. It seems likely that the tendency to put off long-range planning would be particularly strong in the smaller companies where all functions of management fall on one or two individuals. Perhaps the threat of an undistributed earnings tax produces a real benefit by prodding some of those individuals into the essential step of laying out a course for the enterprise to follow.

The Committee reports also consider the circumstances under which an investment in another corporation can be considered the equivalent of engaging in that corporation's business, and therefore give rise to a reasonable need for funds. The opinion is expressed in the reports that acquisition of at least 80 per cent of the voting stock of the other corporation brings the investment into the approved zone, and the decision in cases of lesser ownership will be based on the facts. This rule is not made a part of the Code. It is not intended to apply to ownership of stock of an investment company.

Burden of Proof: In a controversy under section 102 of the 1939 Code, the taxpayer came to bat with two strikes against it. First, if the Internal Revenue Service decided there was an accumulation in excess of reasonable needs, the taxpayer had the burden of proving otherwise; second, such an accumulation was deemed to be for purposes of tax avoidance and thereby made the penalty tax applicable, unless the taxpayer could prove the contrary by the *clear preponderance of the evidence.*

The second rule remains unchanged. Nevertheless, the 1954 Code seems to assure the corporation that in most cases, while it may not score, at least it can come

to bat. Now, upon receipt of formal notice of a proposed deficiency of accumulated earnings tax, it will submit a statement to the Internal Revenue Service. The statement will show "the grounds (together with facts sufficient to show the basis thereof)" for the contention that there is no accumulation beyond the reasonable needs of the business. If and when the issue should reach the Tax Court, as to those grounds the burden of proving error will fall on the government.

In practice, the chance of success in the Tax Court is given great weight in the disposal of issues at all levels of the Internal Revenue Service. Therefore, it is to be hoped that there will be no harassment of taxpayers with respect to the accumulated earnings tax except where there is a clear case of liability.

Personal Holding Companies

A personal holding company is subject to a prohibitive special tax on its "undistributed personal holding company income," at the rate of 75 percent on the first $2,000 and 85 percent on the excess over $2,000. A corporation is a personal holding company if it meets two tests which can be stated in general terms as follows:

(1) More than half the stock is owned by less than six individuals, with each individual considered to own all stock belonging to his family.

(2) At least 80 percent of the gross income is "personal holding company income," a term which includes dividends, interest, gains on securities and commodity futures, and income under some circumstances from rents, royalties and personal services.

"Undistributed personal holding company income" is taxable income less income tax, with certain modifications. Under the 1954 Code, income taxes will be deducted only when accrued, except that a company which has been deducting taxes when paid will continue to do so unless it files an irrevocable election to change to the accrual basis.

Income and Stock Ownership Tests: The provision in the 1939 Code reducing the 80 percent income test to 70 percent, once personal holding company status had been acquired, is abandoned and the test remains at 80 percent for all years. Income from rental of company property to principal stockholders will no longer be included in personal holding company income if personal holding company income other than such rent does not exceed 10 percent of gross income. Only capital gains in excess of capital losses will be considered in the income test.

Charitable foundations, also qualified pension and profit-sharing trusts, will be counted as individuals in determining the ownership of stock. Thus the ownership test would be satisfied if more than 50 percent of the stock belongs to a foundation.

Returns; Statute of Limitations: Personal holding companies have been required in the past to file a special personal holding company return in addition to the corporation income tax return on Form 1120. If the special return was not filed, the statutory period for assessing a deficiency in personal holding company tax would run on indefinitely. Moreover, a penalty of up to 25 percent of the tax would sometimes be asserted for negligence in failing to file the return.

Under the 1954 Code, a single return will serve for both the income tax and the personal holding company tax. There will be a schedule, to be filed with the return, showing the information necessary to determine the application of the income and stock ownership tests. If the schedule is not filed, the statutory period for assessment of personal holding company tax will expire six years after filing the return. If the schedule is filed, the rules applicable to returns generally will apply.

As for the penalty for failure to file a return, it may be that omission of the schedule where it is required would make the return incomplete and therefore insufficient to prevent imposition of the penalty. This possibility and the special statute of limitations, in addition to the potential tax liability, suggest that the need for careful consideration of personal holding company status will diminish very little under the 1954 Code.

Deficiency Dividends: A simple procedure has been devised whereby a corporation can eliminate or reduce a deficiency in personal holding tax. If it is in a position to make a distribution to its stockholders, the distribution will be allowed as a dividend deduction for the year to which the deficiency relates. Three steps are required:

(1) An informal agreement is executed by the government and the corporation establishing the liability for personal holding company tax.

(2) The distribution to stockholders is made within 90 days after the agreement is executed.

(3) A claim is filed for a dividend deduction, in the amount of the distribution, within 120 days after the agreement is executed.

Interest will be charged on the deficiency up to the date of filing the claim and any penalties imposed will not be affected. The Code states that a refund without interest can be obtained, apparently by paying a dividend larger than the amount required to eliminate the deficiency. The deficiency dividend can also be paid by a successor in a tax-free liquidation or reorganization.

The effect of the deficiency dividend provision on years beginning before 1954 is not clear. The Code states that in cases involving those years the term "deficiency divi-

dend" relates only to amounts includible in the basic surtax credit. This information is not of much assistance since the basic surtax credit was defined (insofar as it was generally applicable here) as the sum of dividends paid during the year, consent dividends and the net operating loss credit. Presumably the regulations will clarify this point.

Corporations Filing Consolidated Returns: Where a consolidated return is filed, the 1954 Code extends to corporations generally the privilege, previously available only to railroad groups, of applying the personal holding company income test on a consolidated basis. This might be beneficial, for example, where the income of a closely-held parent company consists entirely of dividends from other members of the group. The dividends would be eliminated in the consolidated return and under the new rule would not constitute personal holding company income. This privilege, in combination with the new exemption of regulated utilities from the two percent tax on consolidated returns, may make it advantageous to transfer ownership of closely-held groups of such companies into holding companies.

The application of the income test on a consolidated basis is not permitted in circumstances illustrated in the following example: A Company and B Company are the parent companies in their respective consolidated return groups. Their gross income is made up as follows:

	A Company	*B Company*
(1) Dividends from companies joining in the consolidated return.....	$ 90,000	$ 90,000
Dividends from other companies: Percentage of paying company's stock owned:		
(2) 50 percent or less.........	8,000	5,000
(3) More than 50 percent......	......	3,000
(4) Operating income (outside sources)	2,000	2,000
Gross income	$100,000	$100,000

A Company must apply the income test on a separate return basis and it is a personal holding company if it satisfies the stock ownership test. B Company, however, will apply the income test on a consolidated basis with the $90,000 dividends in item (1) eliminated. Item (2) supplies the crucial information. To paraphrase the Code provision, A Company received at least 10 percent of its income from outside sources, of which at least 80 percent was personal holding income. So did B Company, except that dividends from a more-than-50-percent-owned company (and not a personal holding company) are not counted for this purpose. In the case of A Company,

if the 10 percent had been only 9 percent, or the 80 percent only 79 percent, it too could have used the consolidated basis.

These percentage tests must be applied to each member company in the group. If any member fails the test as did A Company, the income test cannot be applied on a consolidated basis to that group.

The restrictions illustrated by the example do not apply to a railroad group filing a consolidated return. The income test is applied uniformly to those groups on a consolidated basis.

Acquisition of Loss Corporations

Section 129 was added to the 1939 Code by the Revenue Act of 1943. Its primary purpose was to discourage transactions such as the acquisition of a loss company with high excess profits credit and unused carry-overs, which could be used to reduce taxes on the income of the acquiring company. However, its scope extended further so that it purported to cover almost any acquisition of control (50 per cent or more) of a company, or of property in a tax-free transaction from previously unrelated interests, provided the principal purpose of the acquisition was tax avoidance. The penalty imposed was the disallowance of the desired tax benefit.

The Committee reports state that the effectiveness of the provision has been impaired because of the difficulty in establishing that tax avoidance was *the principal purpose.* The remedy in the 1954 Code for this weakness is a provision (in section 269) applicable where the consideration given by the acquiring interests is substantially less than the sum of (1) the tax basis of property acquired plus (2) the tax benefits made available in the transaction other than benefits reflected in the tax basis in (1). That circumstance in a transaction after March 1, 1954 will be prima facie evidence that the principal purpose of the transaction was tax avoidance. (The dictionary states that prima facie evidence is evidence which, if unexplained or uncontradicted, would establish the fact alleged.)

For example, a profitable company might acquire the stock of a loss company for $1,000,000. The loss company has operating assets with a tax basis of $3,000,000 which are presently worth about $500,000. The assets are sold and the loss offsets the profit on operations transferred to the loss company from the profitable company, resulting in a substantial tax saving to the group. Disregarding any tax benefits, the $1,000,000 consideration is substantially less than the $3,000,000 tax basis of the underlying assets. This fact constitutes prima facie evidence that tax avoidance was the principal purpose of the acquisition. Unless the taxpayer can prove it was not,

the loss on the sale of the operating assets will be disallowed.

According to the Senate report, if a situation is covered not only by section 269 but also by section 382 of the 1954 Code, section 382 will prevail. Section 382 contains limitations on the general allowance of a net operating loss carry-over to the surviving company after a tax-free transaction in two types of situations:

(1) Where new interests acquire as much as 50 percent of the stock of a company within a two-year period and the company does not carry on the same business after the change as it did before, the carry-over will not be allowed.

(2) Where stockholders of a loss company receive in a tax-free transaction less than 20 percent of the stock of the surviving company, there is a proportionate scaling-down of the loss carry-over transferred to the surviving company (for example, if the stock percentage is 10 percent, the surviving company is allowed one-half of the carry-over).

Disallowance of Multiple Credits

After the 1950 excess profits tax law was enacted, it was feared that some corporations would split off portions of their business into new or inactive subsidiaries in order to multiply the effect of the $25,000 minimum excess profits credit. To prevent this the 1951 Act added a provision to the 1939 Code denying such multiple credits unless the taxpayer could prove by the "clear preponderance of the evidence" that the securing of the credits was not a "major purpose" of the transfer. This rule was made to apply also to the $25,000 surtax exemption and was to expire with respect to both items when the excess profits tax expired.

The rule is now made permanent as to the surtax exemption and also to the new $60,000 accumulated earnings credit (see the discussion herein of corporations improperly accumulating surplus). It applies where the original interests have 80 percent control of the new companies (80 percent of voting power or 80 percent in value of all stock). It does not apply to transfers of money even if the money is used to buy stock in trade from the transferor (Regulations, 1939 Code). As in cases under section 269, the Internal Revenue Service is authorized to apportion the tax benefits among the various corporations.

To obtain the allowance of multiple credits, the regulations under the 1939 Code suggested showing that the tax advantage "was not a major factor in relationship to the other consideration or considerations which prompted the transfer."

The reenactment of this provision recalls two axioms:

(1) If the proposed transfer to another company would be desirable for business reasons regardless of the tax benefits, go ahead with it and perhaps the tax benefits will be allowed anyhow.

(2) Before liquidating an existing corporation, give thorough consideration to the tax benefits which may be lost.

A question which may arise under this provision is whether control of the transferee company by, say, only one of several stockholders of the transferor is sufficient to bring the rule into play. Some light is shed by a Tax Court opinion dealing with a similar requirement in the reorganization field. A majority of the Court decided that the required control existed where it was held by the owners of about 70 percent of the stock of the original company.

Corporate Reorganizations and Distributions

By W. H. Davidson
(New York Office)

Sale of Corporate Business

One of the most important and commendable changes made by the new law in the corporate field will facilitate the sale of corporate interests where the assets of a corporation have appreciated in value. When one corporation wishes to acquire the business of another corporation in a taxable transaction it can secure a stepped-up basis for the assets without the imposition of a double tax on the selling corporation and its stockholders. Either of two procedures may be followed.

1. If one corporation buys at least 80 per cent of the stock of another corporation and liquidates the other corporation within two years it will take over the assets of the other corporation at a tax basis equal to the price paid for the stock.

2. If a corporation adopts a plan of complete liquidation on or after June 22, 1954 and distributes all of its assets in liquidation within 12 months, the corporation will, with some qualifications, realize no gain or loss on the sale of its assets within such 12-month period. The new provision applies to inventory only if it is sold to one person in one transaction. The new provision will generally not apply if the corporation is liquidated into its parent in a tax-free transaction.

Since losses as well as gains are not recognized, when assets are to be sold at a loss liquidating distributions should be deferred for at least 12 months.

Though the above provision applies to plans of complete liquidation adopted on or after June 22, 1954 there are special elective provisions applying to cases where all the assets of a corporation were distributed in complete liquidation before January 1, 1955, or cases where the plan of complete liquidation was adopted after December 31, 1953 and before June 22, 1954 and the liquidation is completed within 12 months of the adoption of the plan.

Reorganizations

The reorganization provisions of prior law have in some respects been liberalized.

A corporation may acquire 80 per cent of the assets of another corporation for voting stock and the balance for cash, but liabilities assumed will be treated as part of the cash payment in determining whether 80 per cent of the assets have been acquired for stock.

A subsidiary corporation may acquire the assets of another corporation in exchange for stock of its parent. A corporation may, in exchange for its voting stock, acquire the assets of another corporation and then transfer all or part of them to a subsidiary.

When one corporation issues its voting stock in exchange for the stock of another corporation the transaction will qualify as a reorganization if upon completion of the transaction the acquiring corporation owns 80 per cent of the stock of the other corporation, regardless of how much stock of the other corporation was owned before the offer. The acquiring corporation in previous transactions might have purchased any amount of the stock of the other corporation for cash but this would not invalidate the later exchange of stock.

Securities as "Boot"

If in reorganization exchanges a stockholder receives securities, rather than stock, and surrenders no securities in exchange therefor the entire principal amount of the securities received constitutes taxable boot, and will be taxable as a dividend if the corporation has sufficient earnings. If securities are surrendered in exchange for securities of a larger principal amount the fair market value of such excess represents the taxable boot.

Spin-Offs, Split-Offs and Split-Ups

The treatment of corporate separations has been liberalized in some respects but restricted in others. A corporation may distribute to its stockholders tax-free the stock of an 80 per cent owned subsidiary which it has owned for five years provided the parent and the subsidiary had been engaged in the active conduct of a trade or business for five years and were so engaged immediately after the distribution. The parent need not have been actively engaged in business if immediately before the distribution its only assets consisted of stock of the subsidiary. It is immaterial whether the stockholders surrender stock in exchange for the stock of the subsidiary and the distribution need not be pro rata among all the stockholders.

Where a corporation has been engaged in the active conduct of more than one business for five years it may transfer the assets of one business to a newly organized subsidiary and distribute the stock of such subsidiary to its stockholders tax-free under the same circumstances as referred to in the previous paragraph. Prior law did not contain the five-year requirement nor did it contain the requirement that the assets be those of a separate business. It has been suggested that some spin-offs of real estate which would be tax-free under prior law may not be tax-free under the new

law because of the separate business requirements, but it is hoped that the regulations will interpret the statute more liberally.

The new provision to the effect that distributions need not be made pro rata will permit the transfer of different businesses to different groups of stockholders.

Carry-Overs in Certain Reorganizations and Liquidations

When a subsidiary is liquidated into its parent in a tax-free transaction or when one corporation acquires all the properties of another corporation in a tax-free reorganization the new law permits carrying forward to the surviving corporation 19 items or tax attributes of the corporation distributing or transferring its property.

Chief among these is a net operating loss. An important qualification is that in order to carry forward 100 per cent of the loss, the stockholders of the loss corporation must, as the result of owning stock of the loss corporation, own at least 20 per cent of the stock of the acquiring corporation.

Among the other items or attributes that may be carried forward are capital losses, instalment accounting methods, amortization of bond discount or premium, earned surplus or deficits, contributions to pension plans, etc.

The carry-over provisions apply to liquidations and reorganizations, the tax treatment of which is determined under the 1954 Code.

Special Limitation on Net Operating Loss Carry-Overs

In order to prevent traffic in loss companies the new law provides in substance that if 50 per cent or more of the loss corporation's stock changes hands by purchase during a two-year period the loss carry-over is not allowable unless the corporation has continued to carry on a trade or business substantially the same as that conducted before the sale of the stock.

Transfers to Corporation Controlled by Transferor

Under the old law two or more persons could transfer property tax-free to a controlled corporation in exchange for stock or securities provided the stock or securities received by each was substantially in proportion to his interest in the property transferred. The new law removes the latter requirement. However, one of the transferors may receive compensation income if the disproportion is attributable to services, or there may be a gift tax if attributable to a donative intent.

Stock Dividends and Stock Rights

All dividends in the stock of the corporation or in rights to acquire stock of the corporation will be tax-free unless they are in discharge of preferred dividends for the taxable

year or the preceding year, or unless the shareholders have an option to take cash or other property.

However, in order to prevent so-called bail-outs there are special rules covering the disposition of what the new law calls section 306 stock. Generally, section 306 stock is preferred stock received tax-free as a stock dividend or in connection with a recapitalization or certain other types of reorganization, at a time when the corporation had some earnings or profits.

Assuming that the corporation had sufficient earnings to cover the distribution of the preferred stock at the time of the distribution, if a shareholder sells his section 306 stock at any time, otherwise than by a redemption, the entire proceeds of the sale are treated as ordinary income. If the section 306 stock is redeemed, the proceeds constitute a taxable dividend if the corporation has sufficient earnings or profits at the time of the redemption.

With certain qualifications, the proceeds of the sale or redemption of the 306 stock are not treated as ordinary income if the shareholder disposes of his entire interest in the corporation, or if it is established to the satisfaction of the Treasury that tax avoidance was not a principal purpose of the distribution and disposition.

The new provisions do not apply to stock which was distributed before June 22, 1954.

Redemptions of Stock

Redemptions of stock will not be treated as a dividend to a shareholder if his percentage of voting stock and common stock immediately after the redemption is less than 80 per cent of his percentage of voting stock and common stock before the redemption and if immediately after the redemption the shareholder owns less than 50 per cent of the voting power. There are constructive ownership rules covering stock owned by members of the family, by trusts, corporations, etc. The constructive ownership rules do not apply if the shareholder disposes of his entire interest in the corporation other than his interest as creditor, and does not acquire such interest (including an interest as officer, director or employee) for ten years. The provisions of prior law permitting the redemption of stock for the purpose of paying death taxes have been somewhat liberalized.

Redemptions of stock in partial liquidation of the corporation will not be treated as a dividend. There must be a genuine contraction of the business. There will be deemed to be such a contraction if a corporation conducted two or more separate businesses for 5 years and distributes the assets of one of the businesses or sells such assets and distributes the proceeds. The distribution need not be pro rata.

Where one or more persons control two corporations and sell part

of the stock of the first corporation to the second corporation the proceeds may be taxable as a dividend from the second corporation.

Distributions of Property in Kind

As under prior law a corporation realizes no gain or loss from the distribution of property in partial or complete liquidation. With three exceptions a corporation will realize no gain or loss from the distribution of property in kind even though not in liquidation: (1) If a corporation distributes LIFO inventory it will be taxable on the difference between the LIFO value and the FIFO value; (2) if it distributes installment obligations it will be taxable as under prior law; (3) if the property is subject to a liability which exceeds the basis of the property the excess will be taxable.

Where the distributed property has appreciated in value a corporate stockholder is considered to have received a distribution only in the amount of the tax basis of the property, thus prohibiting stepping up the basis of the property.

Earnings and profits are reduced by the tax basis of the property, regardless of its fair market value. Where the fair market value of the property exceeds the earnings the committee reports indicate that the taxable dividend cannot exceed the earnings even though the earnings exceed the tax basis of the property. There are special rules where a corporation distributes appreciated inventory or unrealized receivables.

F. H. A. Loans

If a corporation has outstanding a loan made, guaranteed or insured by the government, and the loan exceeds the tax basis of the property constituting the security for the loan, any distribution made by the corporation to its stockholders will be taxable as a dividend to the extent of such excess, even though the corporation has an accumulated deficit.

Sale of Treasury Stock

A corporation will realize no gain or loss on the sale of Treasury stock.

Election as to Recognition of Gain in Certain Liquidation

Section 112(b) (7) of the 1939 Code permitted stockholders to defer the recognition of gain on the appreciation in value of the assets of corporations which were liquidated in one month of 1953. The new law makes this provision a permanent part of the Code, provided the liquidation occurs in any one calendar month.

Effective Dates

Generally, the effective date of the provisions previously discussed is June 22, 1954, but there are various exceptions.

Natural Resources

By G. W. Welsch
(Dallas Office)

Editor's Note: This article was the basis of an address by Mr. Welsch before the Houston Chapter of the National Association of Cost Accountants.

One of the objectives of Congress, in rewriting the Internal Revenue Code, was the grouping of related sections in one place under pertinent headings. To a very large extent, this objective was successfully attained. Thus Subchapter I of the 1954 Code, designated "Natural Resources," contains most of the law pertaining specifically to the treatment of income of taxpayers engaged in the extractive industries. However, because of the complexities of the tax law, a complete attainment of this objective was not possible and some sections of particular interest to producers of oil and gas and of minerals are contained elsewhere in the Code. These related sections will be discussed in this paper first, and then the provisions of Subchapter I will be discussed.

Related Sections (other than Subchapter I)

Section 263(c)—Intangible Drilling and Development Expenses—Oil and Gas: Although the 1939 Code contained no specific language which would permit the deduction of intangible drilling and developments costs incurred in the drilling of oil and gas wells, taxpayers were given an election by the Regulations to deduct or capitalize such costs. In 1945, the Court of Appeals for the Fifth Circuit challenged the validity of these regulations.[1] Congress thereupon passed a concurrent resolution affirming the regulations and indicating Congressional intent that such election be permitted. However, such a resolution does have the force of law and some fear existed that the Regulations could be successfully attacked in the courts. This fear has been eliminated by a specific provision in the new Code permitting the deductibility of intangible drilling and development costs, in the case of oil and gas wells, under regulations to be prescribed by the Secretary. The authorization contained in the 1954 Code, for the Secretary to issue regulations, does not, however, grant any new election and taxpayers who failed to exercise a timely election to deduct such costs under the prior Regulations will be required to capitalize expenditures made in future years.

[1] *F. H. E. Oil Co. v. Com'r* 45-1-U. S. T. C. Par. 9200, 147 F (2d) 1002; reh'g denied 45-1-U. S. T. C. Par. 9280, 149 F (2d) 238.

Section 172—Net Operating Loss Deduction: Under the 1939 Code, before an operating loss could be applied to reduce taxable income, certain adjustments had to be made to the income of the loss year and to the income of each year to which and through which such loss was carried. One of the required adjustments was the restoration, in each year, of the excess of percentage depletion over cost depletion. This adjustment practically nullified the benefits of the net operating loss carry-over and carry-back for producers of natural resources and placed those producers with fluctuating incomes at a competitive disadvantage with those with more stable incomes. The 1954 Code abandons the "economic loss" concept, which was the basis for the adjustments required under the 1939 Code, and eliminates the provision requiring the restoration of the excess of percentage depletion over cost depletion. The full effects of this change will not be felt until 1956 and subsequent years because a net operating loss must be carried back to the two preceding years before it can be carried forward. Adjustments to the income of years prior to 1954, to or through which a net operating loss is carried, must be computed under the 1939 Code and therefore the excess of percentage depletion over cost depletion in such years will reduce the net operating loss deduction.

Section 761(a)—Definition of a Partnership: A partnership is defined, in the 1954 Code, as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not . . . a corporation or a trust or estate." This all inclusive definition would appear to classify as a partnership any joint undertaking for exploration for, or development and production of, oil and gas or minerals. However, under regulations to be issued by the Commissioner, any joint undertaking for the joint production, extraction, or use of property, not availed of for the purpose of selling services or property produced or extracted, may be excluded from treatment as a partnership at the election of all of its members. Thus, in effect, most oil and gas or mining joint ventures, as presently constituted, are afforded an election as to whether or not they wish to be treated as partnerships. This resolves the doubt, as to the nature of such joint ventures, which was created by the decision of the Tax Court in the *Bentex Oil Corporation*[2] case, and it enables taxpayers to determine whether or not they wish to come under the partnership sections of the Code.

Section 703—Elections by a Partnership: In addition to creating a

[2] 20 T. C. No. 76; CCH Dec. 19707.

doubt as to the nature of an oil and gas or mining joint venture, the ***Bentex Oil Corporation*** case (supra) raised a question as to who was the proper party to make an election for the expensing of intangible drilling costs, in the case of oil and gas wells, or the deferment of exploration and development costs, in the case of mines, when operations were being carried on in the form of a joint venture. Section 703 of the new Code provides that any election affecting the computation of taxable income from a partnership shall be made by the partnership. Thus, where an oil or gas or mining joint venture elects not to be treated as a partnership, as discussed above, intangible drilling costs will be treated by each member in accordance with his election made individually. Where no election to be excluded from the partnership provisions of the Code has been made, the joint venture must elect whether to capitalize or expense intangible drilling and development costs. Presumably, each new partnership will have a new election.

Section 270—"Hobby Losses" of Individuals: Section 130 of the 1939 Internal Revenue Code provided for the disallowance, to an individual, of losses from a trade or business in excess of $50,000 where for five consecutive years such individual realized losses from the trade or business, in each year, in excess of $50,000. In interpreting this provision, the Treasury ruled that all items allowed as a deduction from the income of a trade or business were to be taken into consideration in determining whether a loss in excess of $50,000 was sustained in any year.[8] The new Code nullifies this ruling by providing that expenditures as to which the taxpayer is given the option, under the law or Regulations, either to deduct as expenses when incurred or to defer or capitalize are not to be taken into consideration in determining whether the loss in each year was in excess of $50,000, even though such expenditures were deducted in arriving at taxable net income on the return. Thus expenditures for intangible drilling and development of oil and gas properties and expenditures for exploration for and development of mineral properties do not count in the computation of the amount of loss for purposes of invoking the limitation factor.

Subchapter I

Natural Resources

Although the sections discussed previously have a direct effect on the taxation of income from the production of natural resources, these sections in whole or in part, also pertain to the taxation of income from other sources. The sections which deal exclusively with prob-

[8] Rev. Ruling 219, IRB 1953-21, 12.

lems relating to natural resources are contained in Subchapter I. This subchapter is divided into three parts:

Part I —Deductions—Sections 611-616.

Part II —Exclusions from Gross Income—Section 621.

Part III—Sales and Exchanges—Sections 631-632.

In discussing these sections emphasis will be placed on the effect of the substantive changes which have been made and only incidental consideration will be given to those sections which have been carried forward unchanged from the prior Code.

PART I—DEDUCTIONS

Sections 611 through 616 of the new Code provide for deductions for depreciation, depletion, exploration expenses and development expenses.

Depreciation—Section 611: As in the 1939 Code, an allowance for the depreciation of improvements is provided for jointly with the provision for depletion. In the early days of the mining industry, both depreciation and depletion, on a unit basis, were taken with respect to March 1, 1913, values and often no separate values were established for depletable and depreciable property. It was only when the percentage depletion allowance was granted that separate valuations became necessary. Because historically these allowances have always been linked, and because many mine operators continue to compute their depreciation on a unit of production basis, the 1954 Code continues the joint treatment. However, Section 167(h) and 611(c) of the 1954 Code made clear, by cross reference, that the provision for the allowance of depreciation in Section 611 is not in lieu of the depreciation methods set out in Section 167. Operators of mines and of oil and gas properties are entitled to use any of the depreciation methods permitted under Section 167, including the "straight-line" method, the "declining-balance at 200 per cent of straight-line" method and the "sum-of-the-years-digits" method.

Depletion—Sections 611–614: Perhaps the most important deduction available to producers of natural resources and the one which has done the most to advance the discovery and development of natural resources in the United States is the deduction for depletion.

Derived from Sections 23(m) and 114 of the 1939 Code, Section 611 grants "a reasonable allowance for depletion" to the holders of economic interests in "mines, oil and gas wells, other natural deposits and timber."

Two changes were made in the grant of the depletion allowance by the new Code. Perhaps the more important of these changes is the enlargement of the definition of a "mine." Improved methods of pro-

duction and increases in metal prices often make it economically feasible to rework tailings piles, culm banks and other mine dumps but the Treasury has consistently held that such refuse of prior mining was neither a "mine" nor a "natural deposit". Although the courts have allowed depletion when such piles or dumps were reworked by the owner and operator of the mine or a successor in interest thereto,[4] the Commissioner ruled that no depletion would be allowable, even where the culm banks or tailings piles were reworked by the original owner of the mine, unless the operation of reworking the material was an integrated step in a mining operation and was the final step in a process which had its beginning when the ore was first removed from the mine.[5]

Under the new Code, the term "mines" includes "deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under Section 613(c)." Adopting the theory upon which the court cases were decided, the new Code permits the depletion allowance where the extraction of the ores or minerals from the tailings piles or culm banks is done by the mine owner or operator or by a successor in interest to the mine owner or operator in a reorganization (Section 381(c)). No depletion is allowable, however, where the reworking of the refuse piles is done by a purchaser of such waste or residue or of the rights to extract minerals therefrom (Section 613(c)(3)). The Senate Finance Committee Report points out that the term "purchaser" does not apply to a lessee upon the renewal of a mineral lease if such lessee was entitled to depletion in respect of the waste or residue prior to the renewal of the lease. The term "purchaser" does include a person who acquires such waste or residue in a taxable transaction, even though such waste or residue is acquired as an incidental part of the whole mine property.

The second change in the grant of the depletion allowance, though important, is of limited application. Although the 1939 Code provided for the apportionment of depletion between lessor and lessee in the case of leases, and between income beneficiary and trustee where property was held in trust, no provision was made for the apportionment of the depletion allowance during the period of administration of an estate. The courts have interpreted this omission to mean that the depletion allowance was available only to the estate and did not follow distributed income.[6] The 1954 Code provides that the deduction for de-

[4] *Com'r v. Kennedy Mining & Milling Co.*, 42-1 USTC Par. 9271, 125 F(2d) 399; *New Idria Quicksilver Mining Co. v. Com'r*, 44-2 USTC Par. 9460, 144 F (2d) 918.

[5] Rev. Rul. 4, IRB 1953-2, 4.

[6] *C. D. Woodard*, CCH Dec. 686, 2 BTA 432; *Brad L. Sneed*, CCH Dec. 19759 (M), 12 TCM 711.

pletion shall be apportioned between the estate and the heirs, legatees and devisees upon the basis of the income of the estate allocable to each (Section 611(b)(4)).

A major change made by the 1954 Code was the elimination of "discovery value depletion" and the extension of the allowance for percentage depletion to all minerals except soil, sod, dirt, turf, water and mosses; and minerals from sea water, air and similar inexhaustible sources. Discovery value depletion was the forerunner of percentage depletion, and has been a part of the tax law since 1918. An allowance of depletion based upon the values added to a property by the discovery of minerals was intended to correct the serious inequity resulting from the taxation of these values without the allowance of any compensating deduction. Difficulties arose in the administration of the "discovery value depletion" provisions and an allowance for percentage depletion was substituted for the allowance for discovery value depletion—first for oil and gas and later for metals and other minerals. From time to time, additional minerals became entitled to percentage depletion until by 1953 very few minerals were entitled to discovery value depletion. The 1954 Code eliminates discovery depletion entirely. Thus, under the 1954 Code, any owner of an economic interest in minerals other than those included within the specific prohibition discussed above, is entitled to an allowance for either cost depletion or percentage depletion, whichever produces the greater deduction.

The 1954 Code changes some of the rates of percentage depletion allowable. No rates are reduced from those allowed by the 1939 Code, but certain rates are increased —particularly those applying to critical and strategical minerals produced from deposits within the United States. Depletion is allowable at 27½ per cent, 23 per cent, 15 per cent, 10 per cent or 5 per cent of gross income, depending upon classification of the mineral. The new Code sets up six classifications. The first five classifications list the minerals entitled to percentage depletion at each of the five rates set out above. The sixth class lists, as being entitled to depletion at 15 per cent, all minerals specifically named as being entitled to a depletion allowance under the 1939 Code but not included in one of the first five classes, and, in addition, it contains the catch-all allowance of 15 per cent to all other minerals, in lieu of discovery value depletion.

End-Use Rule: Both classification 3 and classification 6 provide for the allowance of depletion at 15 per cent of gross income. The necessity for two classifications with the same percentage allowance is found in the so-called "end-use rule," an assumption that the depletion allowance is dependent upon the use to which the

material was put rather than on the nature of the material itself. In an application of the "end-use rule," the Commissioner was sustained by a district court in denying depletion on chromite ore used in refractories for high temperature metallurgical furnaces because the use of the ore for refractories was not a "metallic use" and therefore, the property was not a metal mine.[7] In an extension of the end-use rule, the Regulations under the 1939 Code classify substances on the basis of the usage of the material and the product derived therefrom in establishing the applicable rates of percentage depletion.

Congress recognized the injustice of the end-use rule and severely limited its scope and application in the 1954 Code. Under no circumstances is the end-use rule to be applied to limit or deny the allowance for percentage depletion to those minerals named in classifications 1 through 5. It may be applied to reduce the allowable depletion from 15 per cent to 5 per cent when minerals covered by classification 6 are used or sold for use, by the mine owner or operator, as riprap, ballast, road material, rubble, concrete aggregates or for similar purposes, unless the mineral is sold for such use "on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3)." Thus, while the end-use rule may serve to reduce the allowable rate of depletion to the rate allowable for sand, shale and stone when minerals are used as a substitute for such materials, it cannot be used to deny percentage depletion to a mine owner; it does not apply unless the material is used, or sold for use, for one of the prescribed purposes, by the mine owner or operator; and it cannot be used to foster unfair competition, as for example by giving an advantage to a producer selling asphalt in competition with limestone for road-building purposes.

Gross Income from Property: Percentage depletion is computed as a percentage of the gross income from the property. Gross income from the property, in the case of a property other than an oil and gas property, is defined as "gross income from mining." As in the 1939 Code, the term "mining" is defined as including the ordinary treatment processes normally applied by mine owners or operators in order to obtain a commercially marketable mineral product or products.

As new minerals were added to the list of minerals entitled to the allowance for percentage depletion, questions arose as to what constituted the "ordinary treatment processes" to be included under the definition of mining. Although the 1939 Code contained a list of processes included in the term "ordinary treatment processes," divided into four general classifications, there

[7] *E. J. Lavino & Company v. U. S.*, 47-2 USTC, Par. 9336, 72F Supp. 248 (DC Pa.)

were still areas of dispute and regulations issued under this section of the Code were criticized as placing too strict an interpretation on the statute. For example, although the Tax Court held that the pulverization of talc was a normal treatment process,[8] the Commissioner announced his nonacquiescence in the decision[9], and, in an amendment to the regulations, specifically excluded "fine grinding" as an ordinary treatment process.[10] This and other disputes were resolved in favor of the taxpayers, by the 1954 Code, by the addition of the "pulverization of talc, the burning of magnesite and the sintering and nodulizing of phosphate rock" to the list of ordinary treatment processes in class four. The expansion of the ordinary treatment processes for coal to include "dust allaying" and "treating to prevent freezing" nullifies the recent *Black Mountain Corporation*[11] case in which the Tax Court held that the oil treatment of coal was not an ordinary treatment process and that, therefore, a deduction must be made from the price received for the coal for the cost of and proportionate profits attributable to the oil treatment, in determining the gross income from mining upon which percentage depletion was to be computed.

[8] *International Talc Co., Inc.*, 15 T. C. 981.

[9] 1952—2 CB 4.

[10] T. D. 6031, 1953-2 CB 120.

[11] CCH Dec. 20, 171; 21 TC—No. 83.

Definition of "Property"—Section 614: Although percentage depletion is computed as a percentage of the gross income from "the property" and is limited to 50 per cent of the net income from the property, the tax law has never contained a definition of "the property." The Commissioner has defined a property to be "each separate interest owned by the taxpayer in each separate tract or parcel of land, whether separated geographically or by conveyancing."[12] The courts have not always upheld this definition and have applied practical economic tests,[13] but the Treasury has refused to follow these decisions. Now, for the first time, the Code contains a definition of a property. Section 614 defines a property as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." It would appear that under this broadened definition it will no longer be necessary to reduce the net income of a property by the cost of drilling a dry hole on the same tract or parcel of land from which oil production is being secured. The very fact that the well is dry demonstrates that it did not touch the "mineral de-

[12] G. C. M. 24094, 1944-1 CB 250.

[13] *Black Mountain Corp.*, CCH Dec. 14,852,5 TC 1117, NA., 1946-2 CB 6; *Amherst Coal Company*, CCH Dec. 16,555,11 TC 209, NA., 1949-1 CB 5; *Gifford-Hill & Company, Inc.*, CCH Dec. 16,681,11 TC 802, aff'd, 50-1 USTC Par. 5952, 180 F. (2d) 655.

posit" constituting the property from which the oil subject to the depletion allowance is being produced. Not being on the property, it should not reduce the net income from the property.

The Regulations under the 1939 Code permit a taxpayer to elect to treat as one property two or more mineral interests included within the same tract or parcel of land. The 1954 Code broadens this election to permit a taxpayer to treat as one property any two or more separate operating mineral interests, whether or not contiguous, if such mineral interests constitute part or all of an operating unit, and to treat as separate properties any interests which he does not so elect to combine into the aggregation. The election, once made, is binding for future years, unless permission is procured from the Commissioner for a different treatment. Upon a showing of undue hardship, permission may be obtained from the Commissioner to aggregate royalties contained in a single tract or parcel of land or two or more contiguous parcels of land.

The aggregation of separate interests into one property, if elected, is for all purposes under the Code.

Exploration Expenditures—Section 615: The major change made in this section, derived from Section 23 (ff) of the 1939 Code, was the increase of the $75,000 per year limitation to $100,000 per year. Changes were also made in various applications of the four-year limitation rule to conform to basic changes made by the new Code, to give recognition to the carry-over of certain elections in tax-free reorganizations under Section 381 and to correct inequities where property was received in certain reorganization exchanges.

Development Expenditures—Section 616: Only minor clerical changes were made in this section, derived from Section 23(cc) of the 1939 Code.

Part II
Exclusions from Income

Section 621 is the only section under Part II of Subchapter I. Derived from Section 22(b)(15) of the 1939 Code, it provides for the exclusion from income of certain payments made by the U. S. Government or any instrumentality thereof for the encouragement of exploration for, or development or mining of, certain critical or strategic minerals. No substantive changes were made in this section.

Part III
Sales and Exchanges
Sections 631-632

The third part of Subchapter I carries over into the 1954 Code, with certain modifications, the special treatment granted under the 1939 Code to the owners of timber, or contract rights to cut timber, who

had held such rights for at least six months prior to the beginning of the year in which the timber was cut (Section 117 (h)(1)); to amounts received by the owners of timberlands from grants to others of the rights to cut timber under cutting contracts or leases and amounts received by owners of coal properties from coal royalties (Section 117 (h)(2)); and to the gain realized on the sale of an oil and gas property by an individual who discovered the property (Section 105).

Section 631—Election To Consider Cutting of Timber as Sale or Exchange: Under the 1939 Code, recognition was given to the fact that, when timber was cut, part of the proceeds received from the sale of such timber or of products produced therefrom represented increment in value which had accrued to such timber over a period of years. To permit such increment to be taxed at capital gain rates, the option was given to a taxpayer owning timber, or a contract right to cut timber, for a period of at least six months prior to the beginning of the taxable year in which such timber was cut, to elect to treat the cutting of the timber as a sale of such timber to itself. This right of election is continued by the 1954 Code and the definition of "timber" is enlarged to include "evergreen trees which are more than six years old at the time they are severed from their roots and are sold for ornamental purposes." This extension of the definition of the word "timber" to include Christmas trees nullifies a recent Treasury ruling to the contrary.[14]

When a taxpayer makes the election under this section, the difference between the fair market value of the timber, on the first day of the taxable year in which the timber is cut, and the allowable cost depletion on such timber, is considered as gain or loss upon the sale of an asset used in the trade or business; that is, gain is capital gain but loss is ordinary loss. Such gain or loss is treated as having been realized in the year in which the timber is cut even though the cut timber is on hand at the end of the year. The fair market value used in computing the gain or loss is treated as the cost of the cut timber for all purposes under the Code for which cost is a necessary factor.

The House of Representatives wrote into H.R. 8300 a provision that administrative and other expenses in connection with the holding and measurement of timber, to the extent that these expenses pertain to timber cut during the year, be capitalized as part of the basis of the timber cut. This treatment would reduce capital gain instead of giving the taxpayer an ordinary deduction for the expenditures. The Senate succeeded in deleting this provision. The Senate Finance

[14] Rev. Rul. 217; I. R. B. 1953-22, 2.

Committee Report states that the deletion "in effect continues the treatment of such expenses which is provided under present law and regulations."[15]

Section 631(b)—Disposal of Timber with Retained Economic Interest: The provisions regarding the disposition of timber with a retained economic interest and the disposition of coal with a retained economic interest were combined in one paragraph in the 1939 Code (Section 117(k)(2)). The 1954 Code treats timber separately from coal.

As in the 1939 Code, an owner of timber who disposes of such timber under a contract whereby he retains an economic interest in the timber, is entitled to treat the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof as capital gain or ordinary loss. The 1954 Code makes two substantive changes in this provision. The definition of "owner" is extended to include any person who owns an interest in the timber, including a sublessor and a holder of a contract to cut the timber; and the new Code makes clear that the date of the disposal of the timber is the date that the timber is cut, not the date that the contract for cutting the timber is made, overruling *Springfield Plywood Corporation.*[16]

[15] Report of Senate Finance Committee, P. 81.

[16] CCH Dec. 17946, 15 TC 697.

If payment is made to the owner before the timber is cut, the owner may elect to treat the date of payment as the date of the disposal of the timber.

Section 631(c)—Disposal of Coal with Retained Economic Interest: The provision of the 1939 Code, that where coal which has been owned for a period of at least six months is disposed of under a contract whereby an economic interest is retained, the transaction gives rise to capital gain or ordinary loss, is continued in the 1954 Code. The holding period is measured from the date of acquisition of the coal to the date it is mined. However, one important substantive change is made by the new Code. Amounts expended during the year in the making or administering of the contract under which the disposition occurs and in the preservation of the economic interest retained under the contract, including amounts expended for ad valorem taxes, fire protection, insurance, bookkeeping, technical services, etc., must be applied to reduce capital gain instead of being available as ordinary deductions from income (Section 272). Such treatment is required for these expenses in any year in which any income is received under the contract, regardless of whether any coal is mined but if no income is received in a taxable year in which the expenditures are incurred, the limitation does not apply and the expendi-

tures may be treated as ordinary deductions.

As in the 1939 Code, the 1954 Code provides that no percentage depletion is allowable with respect to coal disposed of under this section and that the capital gains treatment is not available to an owner who is a coadventurer, partner or principal in the mining of the coal.

Section 632—Sale of Oil or Gas Properties: This section is derived from Section 105 of the 1939 Code and is continued unchanged by the 1954 Code. It limits the surtax on any profit attributable to the sale by an individual of oil and gas property, when the principal value has been demonstrated by prospecting or exploration, to 30 per cent of the selling price of the property. It is of very restricted application because if the property has been held for over six months and the individual is not holding the property for sale to customers in the ordinary course of his business, any gain realized will be taxable as capital gain under Section 1231, and the tax will be lower than the limitation provided in Section 632.

Conclusion

The 1954 Code simplifies the structure of the tax law and makes a number of substantive changes. These changes correct inequities, close loopholes and eliminate ambiguities. For the most part, the changes made appear to meet with the approval of producers of oil and gas and of minerals. The basic system for the taxation of natural resources is not changed. The concept of the ownership of an economic interest in minerals in place still governs the allowance for depletion and the rules for determining the treatment to be accorded acquisitions and dispositions of such interests must be ascertained from decisions of the courts under prior law.

Although many areas of dispute have been eliminated by the 1954 Code, questions as to the nature of income received upon the assignment of a "carved-out" in-ore or in-oil payment and whether or not such payments can be exchanged tax-free for economic interests running for the life of the property, still remain to be determined by the courts. In addition questions of interpretation will undoubtedly be raised as the new Code is administered—such as what constitutes an operating unit for the aggregation of properties.

However, the new Code represents a monumental and admirable piece of work and the changes which have been made should do much to stimulate the development of this country's natural resources.

Timing and Recognition of Income and Deductions; Capital Gains and Losses

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GENERAL

The 1954 Code generally retains the basic tax accounting rules of the 1939 Code. However, substantial recognition has been given to "generally accepted accounting principles" in an effort to reduce the divergences which have existed in the past between "tax" accounting and so-called "business" accounting. The problem has not been one of determining what is income or expense, but rather when income or expense should be taken into account in determining taxable income.

Rather than to require a change from existing tax accounting rules, the new rules generally are made elective. Unless otherwise noted, elections can be made without the Treasury's consent for the first taxable year beginning after December 31, 1953 and ending after August 16, 1954 in which the subject items of income or expense first occur. The election cannot be made later than the time prescribed for filing the return for such year, including extensions. With consent, elections can be made at any time. Once made, the elections are binding with respect to succeeding taxable years.

There is no requirement in the Code that taxpayers' books must conform to the selected elective method. As the method is elective, the Treasury may impose this requirement in the regulations to be issued.

WHEN INCOME IS RECOGNIZED

Prepaid Income. Under the 1939 Code, prepaid income was includible in income not later than the time of receipt. The liability to perform was ignored, thus taxing advance receipts as income. This rule, developed by the courts, has become fairly settled law and applied to advance receipts of royalties, rentals, advertising, tickets, tokens, warehousing fees, etc.

The same rule is applicable under the 1954 Code except that accrual-basis taxpayers are allowed an election to defer the reporting of prepaid income generally over the period in which earned. (Sec. 452.) As the election covers all prepaid income received in connection with a particular trade or business, amounts received from a different trade or business are not covered by the same election. For example, if a manufacturer receives income from the rental of a warehouse, a

separate election for rental income is probably required. The proposed temporary rules recently issued state that taxpayers must enumerate in the election each type of prepaid income to be covered.

Prepaid income is defined to mean amounts received in connection with a liability "to render services, furnish goods or other property or allow the use of property." The inclusion of the word "goods" in the definition is not believed to change existing law to the effect that deposits are not income at the time of receipt.

Some difficulty is bound to arise in differentiating between prepaid income and reserves for estimated expenses. If a television set is sold with a warranty contract, the charge for the warranty contract will be a deferred income item if bona fide and part of a separate transaction. If the warranty is merely incidental to and a part of the sale, the charge will not be deferred income. It should be noted that courts in the past have disregarded separate warranty contracts in assessing excise taxes on the combined value of the product, including the warranty.

Where the prepaid income will be earned within a five-year period from the close of the taxable year in which received, the income is reported in the years earned under taxpayer's method of accounting. The method selected must clearly reflect income. An exception is provided where the prepaid amount will be earned within twelve months from date of receipt. In such cases, the amount may be reported as provided by regulations in the year of receipt rather than in the year earned, even though the taxpayer elects the new method for amounts to be earned over a longer period.

Where the prepaid income will not be earned within a period of five years after the year of receipt, the entire amount must be spread equally over the taxable year and the next succeeding five taxable years unless Treasury consent is obtained permitting a different treatment.

Where the prepaid income covers an indefinite period, the estimated portion which will be earned within five years after the year of receipt is reported under taxpayer's method of accounting. The remainder is spread pro rata over the year of receipt and the next five years unless Treasury consent is obtained permitting a different treatment. Assume a calendar-year taxpayer sells $100,000 of tokens in 1954 of which it is estimated that tokens with a value of $88,000 will be redeemed prior to January 1, 1960. The $88,000 will be reported when earned; the $12,000 will be prorated equally over the six years, $2,000 each year.

Where the liability of the taxpayer ends without performance or the taxpayer dies or ceases to exist, the unreported deferred income is includible in gross income in the

year such event occurs. However, successor corporations on the accrual basis are entitled to continue the method elected by the transferor corporation with respect to prepaid income acquired in connection with certain tax-free reorganizations and liquidations.

Receipt under Claim of Right. Property received as income without restriction as to its disposition is taxable to the recipient not later than the time of receipt. If the taxpayer must subsequently return the property or its equivalent, a deduction is allowable only in the year of repayment.

This principle has been applied for example to dividends subsequently refunded because improperly paid or declared, bonuses and commissions received and later restored, and to liquidating dividends subject to payment of corporate taxes.

Taxpayers have incurred serious hardship because of a lower effective tax rate in the year of repayment. The 1954 Code prevents this inequitable result. Section 1341 provides that if a taxpayer includes an item in gross income in one taxable year and in a subsequent taxable year becomes entitled to a deduction in excess of $3,000 because the item or a portion thereof is no longer subject to his unrestricted use, the tax in the subsequent year is reduced by either the tax attributable to the deduction or the decrease in tax for the prior year attributable to the removal of the item, whichever is greater.

This section is inapplicable to bad debts, or to sales of inventory or stock in trade, except refunds made in certain cases by regulated public utilities.

When Expenses Are Deductible

Estimated Expenses. It is generally stated that costs and expenses are deductible for tax purposes by an accrual-basis taxpayer only in the taxable year in which all the events occur which fix the amount and the fact of the liability. This is plainly contrary to good accounting practices in many instances.

Sec. 462 provides for an election by accrual-basis taxpayers to take into account a reasonable addition to each reserve for estimated expenses. The election covers all estimated expenses attributable to taxpayer's trade or business. Where the taxpayer is not accruing all estimated expenses, such as vacation pay, the effect of the election may require that this be done. Since the Code language is specific, the failure to accrue all estimated expenses may invalidate the election. Any clarification on this point must come from the regulations.

To be allowed, the estimated expenses must be a deduction attributable to the income of the taxable year or prior years in which expenses were estimated in accordance with the election. In addition, the Treas-

ury must be satisfied that the expenses can be estimated with reasonable accuracy. If the reserve is based on reliable data or statistical experience of the taxpayer or others in similar circumstances, it will be considered reasonably estimated. Contingent or contested expenses as to which there is no reasonable certainty as to amount are not allowable.

The majority of qualifying expenses will be of a recurring type, although this is not a requirement. The Senate Finance Committee Report lists as examples cash discounts, product guarantees, sales returns and allowances, freight allowances, quantity discounts, vacation pay, and certain liabilities for self-insured injury and damage claims. The Report of Divergences between Tax Accounting and Generally Accepted Accounting Principles, which was submitted in December, 1953, to the House Ways and Means Committee by a committee of the American Institute of Accountants headed by Mr. Schaffer, lists 21 reserves in this category. Whether such items as reserves for maintenance and repairs, social security taxes on unpaid wages, and costs of restoration of property by lessee at termination of lease will be allowed is uncertain. It seems probable that in order to avoid questionable tax deductions, the Treasury regulations may strictly construe this provision to allow only those reserves which are presently customary to taxpayer's trade or business.

The Treasury is granted discretionary power similar to that relating to reserves for bad debts to determine whether reserves for estimated expenses should be allowed. At the close of each taxable year the reserve is adjusted to reflect the experience of the taxpayer. If it is determined that the reserve is excessive, then the excess is restored to income in that taxable year.

This election does not apply to deductions attributable to prepaid income or bad debts, nor to deductions attributable to income in a prior taxable year for which an election had not been made.

Real Property Taxes. In *Magruder v. Supplee,* 316 U. S. 394 (1942), the Supreme Court held that a vendee who purchased property after the tax had been assessed and became a lien could not deduct the prorata share of the tax paid by him. This rule is changed by Sec. 164(d) which requires apportionment between buyer and seller regardless of taxpayer's method of accounting. The amount of the tax allocable to that part of the real property tax year which ends on the day before the date of the sale is treated as a tax imposed upon the seller; the remainder is treated as a tax imposed upon the buyer.

This provision is applicable to sales occurring after December 31, 1953 provided the tax was not al-

lowable to the seller under the 1939 Code in a year ending prior to January 1, 1954.

As a result of the *Supplee* decision, the Treasury has taken the position under the 1939 Code that an accrual-basis taxpayer must deduct the entire tax at the assessment or lien date. Sec. 461(c) of the 1954 Code permits accrual-basis taxpayers to elect to accrue real property taxes ratably over the period to which related in accordance with good accounting practice.

The election is not applicable to any tax which was allowable as a deduction under the 1939 Code in a year beginning prior to January 1, 1954. However, any tax which relates to a prior period but is deductible in the first taxable year beginning after December 31, 1953, is deductible in the first taxable year even though the Sec. 461(c) election is made.

Most accrual-basis taxpayers will not benefit by this election. As the lien date usually occurs prior to or early in the tax year, the effect of the election is to postpone taxpayer's right to deduction.

In case of a sale by an accrual-basis taxpayer who has not made an election, a prorata portion of the property tax is treated as having accrued on the date of sale. If an accrual or cash-basis taxpayer has deducted for any taxable year prior to the sale, an amount in excess of the prorata portion, the excess is includible in income in the year of the sale to the extent of the tax benefit in the prior year.

Organizational Expenditures. Corporate taxpayers are now given an election to deduct organizational expenditures paid or incurred after August 16, 1954. (Sec. 248.) Such expenditures are deductible under the election ratably over a period of 60 months or more as selected by the taxpayer beginning with the month in which the corporation begins business. The period selected by the taxpayer is binding for all subsequent taxable years.

Organizational expenditures are defined as those expenditures which are directly incident to the creation of the corporation, chargeable to a capital account and which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Expenses incident to the sale of stock are not includible under the definition. Reorganization expenses unless incident to the creation of a new corporation are also not includible.

Under prior law, organization expenditures could not be deducted when paid or incurred and, except where the corporation's charter was for a limited period, could only be recouped at the time of corporate dissolution.

Research and Experimental Expenditures. Under prior law, confusion developed as to when research and experimental expenses

were deductible. It was generally stated that they were deductible as current expenses where they were regularly recurring expenses of the business and not attributable to entirely new products or businesses. Sec. 174 of the 1954 Code specifically permits taxpayers to treat research and experimental expenditures incurred in connection with trade or business as either currently deductible expenses or capital expenditures. Where the current expense method is adopted, authorization will be given to capitalize research and experimental expenditures attributable to special projects.

Where expenditures having no ascertainable useful life are capitalized, taxpayers are given an election to amortize such expenditures ratably over a period of not less than 60 months as selected by the taxpayer beginning with the month in which the taxpayer first realizes benefits from such expenditures.

The section contains no definition of "research and experimental" expenditures. The more customary expression is "research and development" expenditures. The change in language may indicate a change in Congressional intention.

Expenditures for land, depreciable or depletable property and exploration expenditures are specifically excluded.

Theft Losses. Sec. 165(e) provides that theft (larceny, embezzlement, etc.) losses are now always deductible in the year in which the taxpayer discovers the loss.

Considerable uncertainty and litigation developed about the application of the prior law wherein the regulations provided that such losses were ordinarily deductible in the year sustained rather than in the year of discovery.

Charitable Contributions Carry-over. Unlike prior law, Sec. 170(b) of the 1954 Code permits corporations a 2-year carry-over of charitable contributions in excess of the 5 per cent limitation. The carry-over is to the two succeeding taxable years in order of time, the succeeding years also being subject to the 5 per cent limitation.

The provision is effective for excess contributions in taxable years beginning after December 31, 1953 and ending after August 16, 1954.

Gain or Loss Not Recognized

Income Taxes Paid by Lessee Corporations. Under prior law, payment or reimbursement by the lessee of the lessor's Federal income tax (arising out of the rental) was includible in the lessor's income as additional rent. Sec. 110 of the 1954 Code provides for the exclusion of such amounts paid under the lease from the lessor's income and nondeductibility of such amount by the lessee where the lessor and lessee are both corporations and the lease was entered into prior to January 1, 1954.

If a lease entered into prior to such date is renewed or continued after such date, it will receive the proposed treatment if renewed or continued in accordance with an option contained in the lease on December 31, 1953.

Sale of Treasury Stock. Under the 1939 Code, gains and losses upon the disposition of treasury stock were recognized if the company was dealing in its own shares in the same manner as it would in the shares of another. However, no gain or loss was recognized if the stock was canceled and new stock issued.

This troublesome technicality is now removed by section 1032 which provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Accounting Periods and Methods

52- or 53-Week Year. The 1954 Code provides that taxpayers who in keeping books, regularly compute income on a 52- or 53-week year may elect for taxable years ending after August 16, 1954 to report income on the basis of such annual period (Sec. 441). The 52–53-week year must always end on the same day of the week which either (1) occurs for the last time in a calendar month, or (2) falls nearest the end of a calendar month.

In the year of transition to a 52–53-week year, there will usually be a short taxable year involved. If a taxpayer is merely changing from the end of the month to the particular day with reference to the end of the month, the income for the short taxable year is not annualized. A short taxable year in excess of 358 days will be treated as a full taxable year, and a short period of less than 7 days will be added to the following year.

In cases where it is necessary to determine for other Code provisions when a taxable year begins or ends, the 52–53-week year is treated as beginning on the first day of the month beginning nearest to the first day of the taxable year, and ending on the last day of the month ending nearest to the last day of the taxable year. For example, a 52–53-week year ending on December 28 will be considered as ending on December 31 for purposes of determining the due date of the return. This rule is subject to one exception. If the tax rate changes during a 52–53-week year, the tax is computed on the basis of the actual number of days occuring before and after the effective date of the change in rates.

Instalment Sales. (Sec. 453.) In the case of any sale of real property or a casual sale of personal property for a price exceeding $1,000 during a taxable year beginning after December 31, 1953, the requirement that some payment be received in

the taxable year of sale in order to qualify for the instalment method of reporting income has been eliminated. If in the year of sale there are no payments or the payments do not exceed 30 per cent of the selling price, the sale will qualify.

For dealers in personal property, double taxation is incurred in changing from the accrual method to the instalment method of reporting income. Income from sales is included in the year of sale under the accrual method and in the year of collection under the instalment method.

This double tax is now partially eliminated by means of a tax reduction in the year the item is included the second time. The reduction is limited to an amount equal to the tax on the item in the prior year but not in excess of the tax on the item in the year of its second inclusion. The limitation forestalls any attempt to take advantage of a change in tax rates.

The relief afforded by this section is seriously limited by the provision which defines the tax attributable to an item as that percentage of the tax for the year which the gross profit from instalment sales bears to the gross income. The limitation therefore depends upon taxpayer's gross income rather than upon taxpayer's taxable income. This restriction will probably deter many taxpayers from changing to the instalment method of accounting who otherwise might do so.

Changes in Accounting Methods. Under the 1939 Code, where the Treasury forced a taxpayer to change its method of accounting because the old method did not clearly reflect income, various court decisions denied the Treasury the right to include in income in the year of change those prior year items which would otherwise escape taxation. However, if the taxpayer requested the Treasury's permission to change, permission would only be granted provided these adjustments were made. The usual items which are restored to income in the year of change from the cash to accrual basis are the opening balances of accounts receivable and inventories.

To correct this incongruity, Sec. 481 of the 1954 Code provides that in any change, whether at taxpayer's volition or at Treasury's insistence, all adjustments will be made in order to prevent amounts from being duplicated or omitted from income. However, no adjustment is to be made for any items in respect of any taxable year beginning prior to January 1, 1954.

Apparently taxpayers seeking permission to change accounting methods in the first taxable year to which the 1954 Code is applicable should be allowed to do so without recognizing adjustments relating to periods covered by pre-1954 law. Whether the Treasury, in granting permission to change, can now impose its usual conditions with respect to pre-1954 items seems

doubtful in view of the expressed statutory language.

In subsequent taxable years, various relief provisions operate to reduce the tax impact of the adjustments.

This section is not applicable to changes from the accrual basis to the instalment basis.

Hybrid Methods of Accounting. Hybrid methods of accounting (consisting usually of a combination of the cash and accrual methods) are specifically recognized by the new Code (Sec. 446). However, when taxpayer is engaged in more than one trade or business, separate accounting methods may be adopted for each.

Capital Gains and Losses

General. The 1954 Code has retained the statutory scheme of the 1939 Code. The changes which have been made have been adopted with a view to correcting obvious inequities in the prior law. The capital gains possibilities in respect to bonds have been seriously limited, but otherwise the effect of so-called "loop-hole closing" provisions is not significant.

Definition. Accounts and notes receivable acquired in the ordinary course of business for services rendered or from the sale of inventory or stock-in-trade are now excluded from the definition of capital assets (Sec. 1221). Consequently any gain or loss from their disposition is ordinary gain or loss.

This provision removes any doubt as to the deductibility as ordinary losses of losses from the sale of accounts receivable or instalment obligations acquired in such transactions. Under prior law, such treatment was allowed only if the taxpayer was also, in effect, a dealer in such obligations.

The provision also closes the "loop-hole" whereby it was sometimes possible to convert ordinary income into capital-gains income by sale of obligations before maturity.

Holding Period. Various minor changes have been made to the provisions determining the holding period of property (Sec. 1223). Prior law permitted tacking of the holding period of a noncapital asset to that of a capital asset where the latter was received in a tax-free exchange for the former. This has now been changed by requiring the asset exchanged to be either a capital asset, or "property used in trade or business" as defined in section 1231.

The rules for determining the holding period of stock acquired by means of a nontaxable stock dividend have been specifically extended to stock acquired by spin-off. Sales of stock acquired in spin-offs occurring prior to January 1, 1954 are also included under the new section.

Prior law was silent as to the holding period of such stock.

Where stock rights received have a zero basis because taxpayer does not elect to allocate basis, tacking of holding periods is still permitted.

The former position of the Internal Revenue Service relating to the receipt of a commodity in satisfaction of a commodity futures contract is reversed. The new law now provides that the holding period of the commodity shall include the period for which the taxpayer held the futures contract.

Bonds. Several important changes concerning amortization of bond premium and sale, exchange and retirement of bonds have been made with an attempt to eliminate the "capital gains play" formerly available in these obligations.

Amortization of Bond Premiums. (Sec. 171.) The definition of bonds and other obligations for purposes of premium amortization has been amended to eliminate the requirement that the instrument have attached coupons or be in registered form. Under prior law, a substantial tax benefit could be obtained by purchase at a premium of tax-exempt obligations which were not in coupon form or registered. The premiums were not amortizable, and consequently became loss deductions upon the maturity of the obligations, whereas the interest received was nontaxable.

Premiums on fully taxable obligations issued after January 22, 1951 and acquired by taxpayers after January 22, 1954, are amortizable to the date of maturity or to an earlier call date provided the earliest call date is more than 3 years after the date of issue. Before this change it was possible to amortize the premium to the call date without restriction.

For example, assume a taxpayer on January 1, 1955, purchases at issuance, a fully taxable $100 bond for $110 with a 10-year maturity but callable at $105 on 30 days' notice from the date of issuance. Taxpayer sells the bond on January 1, 1956 for $107. Under prior law, taxpayer would amortize the premium to the call price in the first year, thus obtaining an ordinary deduction of $5 in 1955, and a capital gain of $2 in 1956. Under the new provision, the amortization deduction in 1955 is limited to $1. Consequently, a capital loss of $2 would be incurred in 1956. Instead of being sold on January 1, 1956, if the bond is called on that date, the new section permits the unamortized premium exceeding the call price to be deducted in that year.

Redemption. (Sec. 1232.) The new law abandons the former restriction permitting capital gains and loss treatment on retirement to only those obligations in coupon or registered form. Redemption of all bonds and other evidence of indebt-

edness issued by a corporation (including any government or political subdivision thereof) receive capital gain or loss treatment on redemption if issued after December 31, 1954 and if they are otherwise capital assets. This change corresponds to the similar one dealing with amortization of bond premiums discussed *supra.*

Nonregistered and noncoupon bonds issued prior to March 1, 1954, which were put in registered form on or before March 1, 1954, qualify for the capital treatment upon retirement. With this exception, the treatment under prior law continues with respect to obligations issued prior to January 1, 1955.

Discount Bonds. (Sec. 1232(a), 1232(b).) Under prior law, the gain recognized upon the sale or redemption (if registered or in coupon form) of discount obligations was capital gain. The only exceptions related to certain governmental obligations issued on a discount basis and payable without interest. In effect, interest income was taxed to cash-basis taxpayers at capital-gains rates because of the discount feature.

This "loop-hole" is now closed by the 1954 Code. The gain realized upon the sale, exchange or retirement of an obligation, issued after December 31, 1954, at a discount and held over 6 months, is taxable as ordinary income to the extent of the allocable original issue discount. The original issue discount is the difference between the issue price and the stated redemption price at maturity without regard to any call price.

This provision is inapplicable to fully tax-exempt obligations, obligations issued at a fractional discount and to taxpayers purchasing obligations at a premium.

The original issue discount is allocated on the basis of the number of complete months that the obligation was held by the taxpayer to the number of complete months from the date of original issue to the date of maturity. Any gain up to, but not exceeding, the allocable original issue discount is taxed as ordinary income; the remainder is a capital gain. Any loss on sale, exchange or redemption is a capital loss.

Bonds with Excess Number of Coupons Detached. (Sec. 1232(c).) Where an obligation in coupon form is sold with an excess number of coupons detached, an artificial discount is created. A new provision has been added effective for purchases after August 16, 1954 of obligations with coupons payable more than 12 months after date of purchase detached. Any gain on the later sale or redemption of such obligations is reportable as ordinary income to the extent of the artificial discount determined at the time of purchase.

Short Sales (Sec. 1233). Gains and losses from short sales of property

are considered as gains and losses from the sales or exchanges of capital assets (except in the case of bona fide hedging transactions). The new law restricts this treatment to only those cases where the property used to close the short sale constitutes a capital asset in the hands of the taxpayer. Consequently, it is no longer possible to realize a capital gain from appreciated stock in trade or inventory by means of a short sale which is covered by delivery of the noncapital asset.

The holding period under present law does not include any period in which a taxpayer is both long and short with respect to substantially the same investment. A "put," an option to sell an asset at a fixed price, is presumed a short sale. Thus, an unexercised "put" in respect to an investment may prevent the realization of a long-term capital gain upon a subsequent sale. To avoid this result, Sec. 1233(c) excepts "puts" acquired on the same day as the investment. If the "put" is not exercised, its cost is added to the basis of the investment. The provision is applicable for acquisitions after August 16, 1954.

Options To Buy or Sell. Under prior law, the gain or loss from the failure to exercise an option was always a short-term capital gain or loss. However, in the case of a sale of an option, the holder (unless a dealer in options) realized a long or short-term capital gain depending on how long the option was held.

Sec. 1234 achieves uniformity of treatment by providing that the sale or exchange of an option, including the failure to exercise the option, is treated as a sale or exchange of a capital asset provided the underlying asset is a capital asset. If a noncapital asset is involved, ordinary gain or loss is realized. The gain to the grantor of the option in all cases will be ordinary income rather than short-term capital gain.

Patents. To provide an incentive to inventors and to eliminate uncertainty in the law, section 1235 has been added to the Code. This section provides for a long-term capital gains treatment upon a property transfer consisting of all substantial rights evidenced by a patent or consisting of an undivided interest therein, regardless of the holding period or the mode of payment. Under prior law, capital gains treatment could only be obtained by an inventor provided he was an amateur inventor. In addition, if the payments were measured by the production or use of the property, the Treasury took the position that ordinary income resulted.

The benefit of this section is limited to transfers by the inventor himself or those who contributed financially towards the development of the invention. In the latter instance, the interest in the property must have been acquired for valu-

able consideration prior to the reduction of the invention to practice. Specifically excluded are all corporations, the inventor's employer and close relatives except brothers and sisters.

The new section does not define what the components of the sale must be in order to qualify. The Senate Finance Committee Report indicates that no change from prior law is intended in this respect. Transfers of lesser interests such as a right to income, or a license limited geographically are not included.

The provision is effective for any amounts received in a taxable year to which the 1954 Code applies regardless of when the transfer occurs. For areas outside the scope of this section, the operation of prior law remains unaffected.

Cancellation of Lease or Distributor's Agreement. Considerable confusion has developed under prior law as to whether amounts received in cancellation of contracts are equivalent to amounts received in sale or exchange of contracts, so as to entitle the recipient to possible capital gains treatment.

Section 1241 provides for capital gains treatment in two cases: (1) Amounts received by a lessee for cancellation of a lease, and (2) Amounts received by a distributor of goods for the cancellation of a distributor's agreement, provided the distributor has a substantial investment in the distributorship. What constitutes a "substantial investment" is not defined.

The provision dealing with amounts received by a lessee for cancellation of a lease represents no change from existing case law, although it is contrary to the present position of the Internal Revenue Service. Existing case law is at present in conflict as to amounts received by a distributor upon cancellation of a distributor's agreement.

Changes Relating to Individuals, Procedure, and Qualified Profit-Sharing and Pension Plans

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Dividend Exclusion and Credit
(*Sections 34 and 116*)

Anyone who followed the tortuous course of HR 8300 through the halls of Congress during the past six months is presumably familiar with the provisions of companion sections 34 and 116 of the 1954 Code relating to the dividend exclusion and the credit for dividends received. Section 116 provides that an individual shall exclude from his gross income the first $50 of dividends which he receives during a taxable year. For the calendar year, 1954, or any fiscal year ending after July 31, 1954, the exclusion will apply to dividends received *after* December 31, 1953. Since the primary purpose of enacting these sections was to eliminate to some extent the double taxation of dividend income, the exclusion is not available for dividends received from certain corporations which are not wholly taxable upon their income. Thus, the exclusion does not apply to dividends received from a life insurance or a mutual insurance company subject to tax under subchapter L; corporations formed under the China Trade Act; corporations which are exempt by reason of their being charitable, religious, scientific or educational in nature; farmers' cooperative associations; and corporations which are partially exempt from taxation by reason of their income arising within possessions of the United States. For the same reason, the exclusion is not available for payments in the nature of dividends but for which a corporation is permitted a deduction, as, for example, dividends paid by mutual savings banks and capital gain dividends of regulated investment companies. The exclusion is limited for ordinary dividends of regulated investment companies when the company derives less than 75% of its ordinary income from dividends. A husband and wife are both entitled to the $50 exclusion but neither may use any portion of the other's. The exclusion of each spouse is good only against that spouse's income.

Under section 34 individual taxpayers are entitled to a credit against tax in the amount of 4% of the taxable dividends which they receive from domestic corporations during any taxable year, and which are included in gross income. The 1954 credit is limited to 4% of such dividends received after July 31, 1954. The dividend credit cannot

exceed the lesser of the tax for the year after application of the foreign tax credit or 4% of taxable income for the year, this latter limitation being 2% for taxable years ending before January 1, 1955. The same rules set forth above are applied in determining whether a payment shall be considered a dividend for the purpose of computing the credit.

Retirement Income Credit (*Section 37*)

The new Code provides relief to retired taxpayers in the lower income brackets by means of a retirement income credit. This relief is available only to persons, or widows or widowers of persons, who received earned income of more than $600 in each of any 10 calendar years preceding the current taxable year. Earned income, for this purpose, is wages, salaries, professional fees and other amounts received as compensation for personal services but does not include amounts received as pensions or annuities. The amount of "retirement income" for a taxable year cannot exceed $1200, reduced by the aggregate amounts received by the taxpayer from social security, railroad retirement, and other tax-exempt annuities or pensions; and, if the taxpayer is less than 75 years of age, reduced by earned income in excess of $900 received during the year. Tax-exempt income for this purpose does not include any amounts excluded from income by reason of the statutory provisions relating to annuity payments, life insurance proceeds, compensation for injuries or sickness, accident and health plans and amounts received from employees' trusts or annuities. Thus, if the taxpayer receives social security benefits of $100 per month or more, he will obtain no benefit from section 37. Likewise, if he is less than 75 years of age and earns more than $2100 during a taxable year, section 37 will not benefit him.

The mechanics of section 37 are simply to allow taxpayers a credit equal to the rate (currently 20%) of tax on the first $2000 of taxable income multiplied by (1) retirement income, or (2) $1200 reduced by the afore-mentioned items, whichever is lesser.

Dependency Exemptions (*Sections 151, 152*)

Although the amount of the dependency exemption was retained at $600, the definition of dependent has been liberalized by sections 151 and 152 of the new Code. Non-relatives may now qualify as dependents if they are members of the taxpayer's household and the taxpayer's home is their principal abode. Thus, foster children and children in the process of being adopted, as to whom there was much inequity in the 1939 Code, will now qualify as dependents. The requirement that a dependent must not have earned more than $600 during a taxable year has been eliminated in two common situations. Any

child, stepchild or adopted child of the taxpayer who is less than 19 years of age may earn an unlimited amount and still qualify as a dependent, providing the taxpayer furnishes more than one-half the child's support. The $600 income limitation is also abolished for a taxpayer's child who for at least five calendar months during a taxable year is a full-time student at an educational institution or for the same period is pursuing a full-time course of on-farm training. Scholarships at regular schools or colleges will not be included in determining whether the taxpayer contributed more than one-half of the child's support. The much-discussed mutual support agreement is also included in the 1954 Code. Where several taxpayers cooperate in supporting a person, who otherwise would constitute a dependent except for the fact that no one of the taxpayers supplied more than one-half of the support, the taxpayers may by written agreement among themselves determine which of them will be entitled to the dependency exemption for the taxable year. The restrictions upon this provision are:

(1) More than 50% of the support must be furnished by persons who could otherwise claim the dependency exemption if it were not for the 50% requirement; and

(2) the person who claims the exemption must have furnished more than 10% but less than 50% of the support for the year.

Meals and Lodging Furnished by Employers (*Section 119*)

Under the 1939 Code the question of whether meals and lodging which were furnished by an employer to an employee constituted income was particularly difficult to answer. Involved were questions of the application of the "convenience of the employer" rule as well as the determination of whether the meals and lodging were intended to be compensatory in nature. Under section 119 the compensatory intent of such meals and lodging is no longer important. The convenience of the employer rule has been codified so that meals are excluded from gross income if they are furnished on the business premises of the employer. In the case of lodging the employee must be required to accept the lodging on the business premises of his employer as a condition of his employment.

Carrying Charges on Installment Contracts (*Section 163*)

An additional deduction has been granted to taxpayers who purchase personal property under installment contracts. The nature of such contracts frequently makes it impossible for the purchaser to distinguish between carrying charges, service charges, and interest. Under the 1939 Code if such a distinction was impossible, the purchaser was not entitled to an interest deduction.

Under the provisions of section 163 of the new Code, so long as the carrying charges are separately stated in such a contract, the payments thereunder shall be considered to include interest equal to 6% of the average unpaid balance of the contract during the taxable year. The average unpaid balance is defined as the aggregate of the unpaid balances outstanding on the first day of each month beginning in the taxable year, divided by twelve. In no event can the interest so computed exceed the actual carrying charge applicable to the taxable year.

Charitable Deductions (*Section 170*)

The ceiling on the deductibility of charitable contributions has been raised considerably by the 1954 Code. Section 170 raises the ceiling from 20% to 30% of adjusted gross income for gifts to religious organizations, full-time educational organizations and hospitals. The ceiling applicable to gifts to other qualified charitable, educational and scientific organizations remains at 20%. The aggregate of charitable contributions of all types cannot exceed 30% of adjusted gross income. The new Code also makes it easier for a taxpayer in the top bracket to qualify for unlimited charitable deductions by providing that the limitation shall not apply if during the current taxable year and eight of the ten preceding taxable years his contributions plus his income taxes exceeded 90% of his taxable income. The 1939 Code required these conditions to be met for the ten consecutive years preceding the current taxable year. Under the new Code it is no longer necessary to recompute the charitable deduction for a year which is affected by the carry-back of a net operating loss. Nonprofit cemetery and burial companies have been added to the list of organizations which qualify for 20% ceiling contributions. Many relatively minor but disturbing problems concerning corporate contributions will be eliminated by the new provision which permits a corporation which makes charitable deductions in excess of 5% of its taxable income to carry forward such excess to the succeeding two taxable years in order of time. It is to be noted that this carry-forward provision does not increase the 5% limitation in the succeeding years. Thus, if the corporation makes actual contributions in the succeeding year in an amount equal to 5% of its net income for such succeeding year, it may lose the benefit of the carry-forward from the earlier year.

Child Care Expenses (*Section 214*)

The new Code provides for the deduction of child care expenses by a woman, a widower or a legally divorced or separated man in an amount not to exceed $600 for any taxable year, provided the payments

are made to a person for whom the taxpayer is not allowed a personal exemption during the taxable year. A child is defined for the purpose of the Code as a son, stepson, daughter or step-daughter who is less than 12 years of age or, regardless of age, is physically or mentally incapable of caring for himself. A married woman is not permitted this deduction unless she files a joint return with her husband and, in such case, the deduction shall be reduced by any amount by which the adjusted gross income of the husband and wife exceeds $4500. The foregoing restriction shall not apply if her husband is mentally or physically incapable of self-support.

Discharge of Indebtedness (*Section 108*)

The rule regarding the excludability of income produced by discharge of indebtedness has been expanded. The 1939 Code provided that income attributable to the discharge of a corporation's indebtedness which was evidenced by a security should not constitute taxable income if the corporation agreed to reduce the basis of its property by the amount of such income. The new law eliminates the requirement that the debt is required to be evidenced by a security and in addition makes the rule applicable to individual debtors so long as the debt in question is incurred in connection with business property.

Gain on Sale of Residence (*Section 1034*)

Section 1034 continues the provisions of the 1939 Code according nonrecognition to gains upon the sale of a taxpayer's personal residence where the taxpayer purchases a replacement residence within one year of the sale. Under the 1954 Code however, a gain realized from the sale is reduced by amounts (not otherwise deductible) paid within thirty days after the date of the sale for work actually done during the 90-day period prior to the sale date for the purpose of repairing and/or conditioning the property for sale (fixing up expenses). Minor amendments have been made to the provision relating to the suspension of the replacement period while taxpayer is in the Armed Forces. Section 1034, unlike its predecessor section 112(n), is made specifically inapplicable to involuntary conversions of personal residences after December 31, 1954. Involuntary conversion of residences are now covered by the regular involuntary conversion provision, section 1033.

Long-Term Compensation (*Section 1301*)

The provisions requiring the receipt of more than 80% of the total compensation in a single taxable year and the general operative provisions of former section 107 remain unchanged.

There is, however, a material change in the definition of the work

for which payment is covered by this section. The 1939 Code referred to "compensation for personal services" and the committee reports indicate that Congress was unhappy with the way taxpayers attempted in some cases to combine various sets of services so as to qualify under the 36-month provision and in other cases to separate various sets of services in order to meet the requirement of receiving at least 80% in a single taxable year. The reports indicate Congress substituted the phrase "an employment" because it believed that the term "employment" would produce more distinct tax results than did the term "compensation for personal services." The reports indicate that the "employment" must relate to a particular project, such as a lawsuit, and not to a set of unrelated services which the taxpayer may have performed for the same person. Conversely, an employment will include performance of personal services to effect a particular result regardless of the number of sources from which compensation for such services is received. The other substantive change in section 1301 relates to the special rules applicable to partnerships and the receipt of long-term income. The general rule is that a member of the partnership is entitled to spread his income only if he has been a member of the partnership continuously for a period of 36 months.

Real Property Subdivided for Sale (*Section 1237*)

Section 1237 will offer relief to many noncorporate taxpayers. One of the most common controversies under the 1939 Code was whether a taxpayer was engaged in the business of selling lots so as to forestall the applicability of capital gains rates to profits from the sale of the lots. Whether he was so engaged depended upon several factors, one of the most important of which was whether he had subdivided the property. Section 1237 provides generally that the mere subdivision of real property will not in and of itself be evidence that the property was held primarily for sale to customers in the ordinary course of his trade or business. The section has no application to a taxpayer who is otherwise a dealer in real property and it likewise has no application if the taxpayer holds any other real property for sale in the ordinary course of a trade or business. This section will not apply if the particular property in question was ever held by him for sale in the ordinary course of a trade or business. In order to obtain capital gain the taxpayer must not have made substantial improvements upon the property so as to substantially enhance its value. Substantial improvements include those made by the taxpayer or members of his family, a corporation which he owns, a partnership in which he is

a partner, a lessee if the improvement constitutes income to the taxpayer, or a political subdivision if the improvement constitutes additional basis to the taxpayer. Property will not qualify for the benefits of this section until it has been held for at least five years by the taxpayer unless he acquired it by inheritance or devise, in which case there is no minimum holding period. Certain necessary improvements are permitted provided the taxpayer holds the property for at least ten years. Such improvements include the building or installation of water or sewer facilities or roads, providing such improvements are necessary for the purpose of rendering the property marketable at the prevailing local price for similar building sites. This latter rule that such improvements will not result in the taxpayer's losing capital gain treatment is severely restricted by the condition that the taxpayer must agree not to claim additional basis for the cost of such improvements.

Once it has been determined that property comes within the scope of section 1237, the sale of all lots during and subsequent to the year in which the sixth lot is sold produce ordinary income to the extent of 5% of selling price and the balance of the profit will be entitled to capital gains treatment.

The section contains a rather peculiar provision relating to the allocation of expenses which are incurred in connection with the sale. Such expenses will be attributed first to the portion of the selling price which constitutes ordinary income and the balance of any such expenses shall be used to reduce the selling price of the property which is entitled to capital gains treatment.

There appears to be nothing in section 1237 which overrules the line of cases which holds that a real estate dealer may hold real property as an investment in certain circumstances.

MEDICAL EXPENSES (*Section 213*)

Medical expenses are deductible under the new Code to the extent that they exceed 3% of adjusted gross income instead of 5% as provided in the 1939 Code. Retained in the law is the provision that if either taxpayer filing a joint return is 65 years of age or over, medical expenses for both taxpayers are not subject to the 3% limitation. The 3% limitation remains applicable, however, for the dependents of such taxpayers. Under the new Code, medicines and drugs are taken into account in computing the medical deduction only to the extent that the cost of such expenses exceeds 1% of adjusted gross income. It is to be noted that the 1% is applied for the purpose of determining the amount of expenditures made for medicines and drugs which are actually medical expenses. Thus, if a taxpayer having adjusted gross in-

come of $5,000 for the year spent $100 for medicines and drugs, the 1% limitation would be applied and only the $50 in excess of the 1% limitation would be included in the taxpayer's other medical expenses for the purpose of applying the 3% rule. The maximum medical expense deduction has also been doubled under the 1954 Code.

The medical expense deduction has been liberalized by the addition of a section providing that medical and hospital expenses incurred by a taxpayer which are paid out of his estate within the year succeeding his death shall be deductible in the final return of the taxpayer. This latter provision will be effective only if such expenses are not allowed as a deduction for estate tax purposes and a waiver is filed to that effect.

The question of whether living expenses can be deductible as medical expenses where the taxpayer is required to travel to another area for his health has apparently been laid to rest by the new Code. Section 213 impliedly eliminates living expenses by providing that only the transportation primarily for and essential to the medical care will be deductible.

Amounts Received under Annuity Contract (*Section 72*)

The radical change in the taxation of annuity payments has been one of the most publicized changes in the 1954 Code. Nowhere in the new Code is there any 3% rule. The new provisions use the term "exclusion ratio" as the factor which will hereafter be applied to annuity payments in order to determine the nontaxable portion thereof. Thus, in the usual case of an annuity purchased by a taxpayer under which annual payments are agreed to be made for the annuitant's lifetime, the annuitant will divide his cost by his life expectancy at the time the payments begin in order to obtain the tax-free portion of each annual payment. The difference between the tax-free portion and the total he receives during the year will constitute taxable income. In the case of annuities under which the first payment date was prior to January 1, 1954, the annuity starting date shall be January 1, 1954 and the exclusion ratio shall equal the investment in the annuity reduced by the amount received tax-free under the old 3% rule, divided by the annuitant's life expectancy on January 1, 1954.

Similar rules apply to annuities providing for payments for a period certain. The Code provides that the exclusion ratio shall be determined by dividing the investment in the contract by the expected return thereunder. Thus, if a taxpayer purchases an annuity for $50,000 which will pay him $5,500 annually for ten years, the exclusion ratio is $50,000 divided by $55,000 or 10/11ths, so that he will report only 1/11th of each annual payment as income.

Under the 1939 Code the 3% rule was applicable if the annual payments were determined by reference to life expectancy or actuarial tables. In any other contract of a similar nature but lacking the actuarial factor, the taxpayer was entitled to recover his cost before reporting any income from the contract. The 1954 Code retains this cost recovery rule as to any amount which is received under an annuity contract but is not actually an annuity payment. Dividends are an example of such payments. If dividends are received prior to the starting date for annuity payments, the dividends will constitute nontaxable return of basis but will, of course, have the effect of reducing the exclusion ratio. If they are received after the starting date they are fully taxable because they were not included in computing the exclusion ratio, which under the 1954 Code remains constant throughout the period of the annuity.

When proceeds of an annuity, endowment, or life insurance contract (other than those paid by reason of death of the insured) are received in a single taxable year the tax shall not be greater than if such proceeds had been received ratably during the current and the two preceding taxable years.

The 1939 Code applied the 3% rule to joint and survivor annuities but in the application of such rule the survivor was entitled to use as his cost the value at which the annuity contract was included in the estate of the deceased annuitant. This rule will no longer apply to any annuity where the death of the first annuitant occurred after December 31, 1953. This is true since the exclusion ratio once established will remain constant throughout the lives of joint annuitants. In order to eliminate to some extent the double taxation which would be caused by requiring an estate tax to be paid without granting a step-up in basis, the surviving annuitant will be entitled to an ordinary deduction for a prorata part of the estate tax accruing to the first annuitant by reason of the contract. The former rule permitting a step-up in basis will remain applicable in the case of any joint and survivor annuity where the first annuitant died in 1951, 1952, or 1953.

If the annuity contract contains a refund provision or guarantees payments for a number of years certain the investment in the contract must be adjusted in order to determine the exclusion ratio. The adjustment is required because the Code specifically provides that the refund beneficiary shall not be required to include as income the refund he receives. The adjustment is determined by reference to actuarial tables prescribed by the Commissioner and in general terms will be equal to the actuarial value of the refund provisions based upon an interest rate of zero and determined as at the annuity starting date.

If an employee's annuity involves amounts contributed by his employer and if the employee will receive during the first three years after the annuity starting date amounts in excess of his own contribution, the employee will use the cost recovery rule and exclude all payments until he has recovered his cost. Thereafter all payments will constitute taxable income.

Under many contracts, of which endowments are an example, the owner has the option at maturity date to accept annuity payments for various periods in lieu of a lump-sum amount. Under prior law it was held that if the contract owner elected at or after maturity date to take an annuity he had constructively received interest income in the amount of the difference between his cost and the face value of the policy at maturity. No longer will this be true if he makes such an election within 60 days after the lump sum becomes payable. If he makes the election the installments shall be taxed as annuity payments in accordance with the afore-mentioned rules. Apparently, if he makes such an election more than 60 days after the lump sum becomes payable the lump sum will be taxed under the cost recovery rule and subsequent payments will be taxable as annuity installments. He will then include in computing the exclusion ratio the amount of income he was held to have realized in the year he exercised the option.

Continued unchanged is the provision that if an amount is held under an agreement to pay interest, such interest will be includable in taxable income.

Rules relating to the taxation of annuities and the actuarial tables necessary to determine exclusion ratios were published in a proposed Treasury decision in the Federal Register of August 27, 1954.

Soil and Water Conservation Expenditures (*Section 175*)

This section permits a taxpayer who is engaged in the business of farming to deduct amounts which he pays or incurs for the purpose of soil or water conservation or for the prevention of erosion of farming land. The deduction for such expenses cannot exceed 25% of gross income from farming during the taxable year. Such gross income is not limited to income produced from the land for which the expenditures are made. If during any taxable year a taxpayer incurs expenses in an amount greater than 25% of such gross income, the excess is a carry-forward to succeeding taxable years in order of time and without limitation as to the number of years of carry-forward. For no year, however, shall the deduction be greater than 25% of gross income from farming for the year. Expenses included in this election include those for leveling; grading and terracing; coutour plowing; the construction,

control and protection of diversion channels, drainage ditches, earthen dams, water courses, outlets and ponds; and the eradication of brush and the planting of windbreaks. The election does not apply to expenditures for structures or facilities which are subject to a depreciation allowance. Also included in such deductible expenses are assessments levied by soil, water conservation or drainage districts for the purpose of paying expenses which would be deductible under this section if the taxpayer had paid them directly. A taxpayer may adopt this treatment of expenses without consent of the Internal Revenue Service in the return for the first taxable year beginning after December 31, 1953 and ending after August 16, 1954 in which he incurs such expenses. He may adopt this method at any time with the consent of the Commissioner but once having adopted the method he must continue to use it for all subsequent years, unless he gets the Commissioner's permission to change.

Split Income by Surviving Spouse (*Section 2*)

The new Code provides that a surviving spouse may file what is, in effect, a joint return for the first two taxable years following the death of his spouse, providing he maintains as his home a household which is the principal place of abode of a son or daughter for whom he is entitled to exemption as a dependent under section 151. This privilege is available only if the taxpayer has not remarried before the close of the taxable year for which the return is being filed, and only if the taxpayer could have filed a joint return with his spouse during the year of the spouse's death.

Effective Dates (*Section 7851*)

In accordance with the general rule relating to most of the income tax provisions of the new Code, the afore-mentioned sections relating to individuals are applicable to taxable years beginning after December 31, 1953 and ending after August 16, 1954. However, in a few instances there are different effective dates contained in the operative sections. Thus, the dividend credit under section 34 applies only to dividends received after July 31, 1954. Section 1237 providing for the 5% ordinary income treatment upon real property subdivided for sale applies only to sales occurring after December 31, 1953, except that for the purpose of deciding when the sixth lot is sold, there shall be taken into account all sales since December 31, 1948. The annuity provisions, with the exception previously noted relating to joint and survivor annuities where the first annuitant died before January 1, 1954, shall apply to all annuity payments received after December 31, 1953.

Declaration of Estimated Tax (*Section 6015*)

The requirements for filing declarations of individual income tax have been considerably narrowed so as to eliminate the need for many taxpayers to file declarations. The new rules provide that if an individual can reasonably expect to receive no more than $100 of income other than compensation subject to withholding, he is required to file a declaration only if such compensation income can be reasonably expected to exceed $5,000 in the case of a single taxpayer or a married taxpayer who must file a separate return, and $10,000 in the case of a head of household or a married individual (or "surviving spouse") filing a joint return. If a taxpayer expects to receive more than $100 of income other than wages he must file a declaration if his expected income exceeds $600 times the number of exemptions to which he is entitled plus $400.

The provisions of the old Code that a final return filed by January 15 will be considered to be either a declaration, if the requirements for filing a declaration are first met in the last quarter, or will be considered an amendment, if a prior declaration was filed, are retained in the 1954 Code except that the deadline for filing such a final return for 1955 and subsequent years has been extended to January 31. The new rules applicable to filing of declarations pertain to income which will be received in the calendar year 1955 or fiscal years beginning after December 31, 1954.

Filing Dates

Individual and partnership returns, and declarations of estimated tax will hereafter be due on or before the 15th day of the fourth month following the close of the taxable year. Payments of tax and estimated tax are due upon the filing date as they were under the 1939 Code. It should be noted, however, that although the declaration and the first payment are due on April 15th, the second, third and fourth installments will continue to be due on the 15th days of June, September and January, respectively.

Section 7502 now provides that claims, documents, petitions in the Tax Court, etc. (but not returns) will be deemed to be filed upon the postmarked date. If sent by registered mail, the date of registration shall be deemed to be the postmarked date. Until the promulgation of regulations under this section, extreme care should be taken in mailing such documents by the use of a postage meter machine since the Code provides that the Commissioner may make such rule, if he deems appropriate, for the use of such machines.

STATUTE OF LIMITATIONS
(*Section 6501*)

The new Code makes a very commendable change in the statute of limitations by providing that a uniform 3-year assessment period shall be applicable to all taxes. The period of limitations will still begin to run with the due date of the return or from the actual date of filing in case of a return filed after the due date. A major change has been provided in the statute of limitations applicable when a substantial amount of income has been omitted from the return. The period of limitations in such a case has been extended to six years but the new test for applicability of the extended period is an omission of 25% of gross receipts without diminution by cost of sales or services. The Code further provides that hereafter if income is omitted from the tax computation but the return actually discloses the amount and the reason for omission the six-year statute will not apply.

PENALTIES (*Section 6651*)

Uniform penalties now apply to all income tax returns. Failure to file a return which is not due to reasonable cause, but to wilful neglect, will be penalized by an assessment of 5% of the net amount shown due with the return for each delinquent month or fraction thereof, but not exceeding 25% in the aggregate. Failure to file Forms 1099 and W-2 now results in a penalty of $1 for each such return which is not filed, not to exceed $1,000 in the case of any single taxpayer. Forms 1099 are now required to be filed by persons engaged in business, who must report payments in excess of $600 in the nature of rent, salaries, wages, premiums, annuities, compensation emoluments or other fixed or determinable income not subject to withholding. The Commissioner has authority to require all corporations to file information returns upon interest paid, regardless of amount.

Penalties for failure to file a declaration have been eliminated but the provisions providing for penalties for substantial underestimate of tax have been considerably broadened and made automatic. No penalties will be assessed if the installment payments are at least equivalent to the installments which would have been payable based on the tax shown on a return filed by the taxpayer for the preceding taxable year of twelve full months or if the payments actually made are equivalent to the tax computed at current rates and exemptions but otherwise based on the previous year's income.

If penalties are applicable they amount to 6% per year upon the difference between what should have been paid if the estimate were 70% (66⅔% for farmers) of the final tax shown on the return and the amounts which were actually paid.

Payments upon declarations are taken into account upon the date of payment and withheld taxes are considered paid equally upon each installment date unless the taxpayer shows the actual payment dates for withheld taxes. It is to be noted that this 6% is specifically designated as an addition to the tax and is therefore not deductible as interest.

A taxpayer who receives the bulk of his income during the latter months of his taxable year can protect himself from penalties by filing a declaration and paying installments equal to at least 90% of the tax computed on the actual income of the full months of his taxable year prior to the declaration date.

Although the Code itself makes no provision regarding the method a partner shall use in computing his estimate, it is well worth noting that the Committee Reports indicate that at any installment date a partner should consider his distributable share of the partnership's income for the months of the partnership year completed prior to his installment date.

Qualified Profit-Sharing and Pension Plans (*Section 401 et seq.*)

For the most part the new Code made very little change in the provisions relating to qualified profit-sharing and pension plans. The only substantial change made in the requirements for obtaining an exemption is that hereafter a trust must be created or organized in the United States in order to qualify. If the situs of a trust, however, is the only bar to its exemption the beneficiaries of the trust will be taxed as though qualified and contributions by resident employers will likewise be deductible. Another change worthy of thought is that an accrual basis taxpayer who formerly had 60 days following the end of the taxable year to make an actual payment of his contribution in order to claim the deduction in the year of accrual may now make such payment at any time prior to the due date (including extensions) for filing the return for the year of accrual.

Relief has been granted to groups of corporations which constitute affiliates as defined by the consolidated return sections. If such a group has a common profit-sharing or stock bonus plan, which is based upon profits, and a member of the group is unable to make its contribution by reason of having no earnings, other members of the group may contribute the deficiency on behalf of the loss corporation. Unless a consolidated return is filed, deductions by the corporations who actually make the contribution are allowable only in the ratio of the profit of each to the aggregate profit of all profitable affiliates. For determining the deductibility of such contributions as carry-forwards, however, they will

continue to be considered contributions of the loss affiliate for whom they were made.

TAXATION OF UNRELATED BUSINESS INCOME OF EMPLOYEES' TRUSTS (*Sections 500-515*)

The Internal Revenue Service now has means whereby it may withdraw the exemption granted to an employees' trust by reason of the trust engaging in prohibited transactions. Prohibited transactions for this purpose have generally the same meaning that they had in the 1939 Code relating to the loss of exemption of charitable, religious, scientific and other tax-exempt foundations and organizations. Thus, if, after March 1st, 1954 an employees' trust loans any part of its income or corpus to the employer without adequate security and reasonable interest, pays unreasonable compensation to the employer, makes services available to the employer on a preferential basis, makes purchases from the employer for excessive consideration, or otherwise engages in any transaction with the employer which substantially diverts its income or corpus, it will lose its income tax exemption. Savings clauses are included to permit the orderly liquidation of prohibited liabilities which were in existence on March 1, 1954. Loss of an exemption will result in the trust's income becoming taxable. Thereafter contributions to the trust, although still deductible by the employer, may be taxable currently to the employee if the employee's rights are nonforfeitable at the time the contribution is made. Employees will no longer be entitled to long-term capital gain treatment from lump-sum distributions and they will compute their tax for current distributions in accordance with annuity rules.

The unrelated business income tax formerly imposed only upon tax-exempt charitable, religious, scientific and similar organizations, now applies to employees' trusts. The rules for determining the taxability of an employee trust are quite similar to those applied to foundations. Rents are taxable if there is business lease indebtedness upon the property, similar to the former Supplement U lease indebtedness. It is perhaps worth noting that the unrelated trade or business of a charitable or scientific foundation means any trade or business which is ***not substantially related*** to the exercise or performance of the organization's exempt functions, while in the case of a trust there is no such limitation, and unrelated trade or business means any trade or business normally carried on by the trust or by a partnership of which it is a member.

RESTRICTED STOCK OPTIONS (*Section 421*)

While there were a great many changes made in the provision relating to qualified stock options, most of them were for the purpose

of providing clarification and certainty. Options granted after June 18, 1954 must be exercisable within a period of not more than 10 years in order to qualify. Variable price options, that is, those under which the price to be paid by the employees is not determinable at the time of grant of the option because it is related to the market value of stock at some future date (usually the date the employees exercise the option), will now qualify providing the option price is at least 85% of the value of the stock at the time of grant of the option. When an employee disposes of stock which he acquired under a variable price option he must compute the spread between fair value at the time of disposition and his option price and the spread between fair value at the time the option was granted over the option price (computed at the date of grant). The lesser of these two amounts must be included in gross income as compensation in the year of disposition. The new provisions clarify the tax effect of an employee's premature disposition of stock which he acquired under a qualified option. In such an event the employee must report compensation income and the employer is entitled to an additional deduction in the year of disposition so that there is no requirement of reopening the return for the year in which the option is granted. Under the 1939 Code an option could not qualify if it were granted to an employee who owned more than 10% of the stock of the employer. This limitation has been removed if the option price is at least 110% of fair value at granting date and if the option is exercisable only within five years from the date of grant or if it is, in fact, exercised prior to August 16, 1955. The new provisions allow an estate or the heirs of an employee to exercise an option granted to the deceased employee with the same tax benefit the employee would have received. The estate or beneficiary in such a case, however, may sell the stock immediately without disqualifying itself for the benefits of the section. The new Code provides that death of an employee who owns stock which he acquired under a qualified option shall constitute "disposition" of such stock. The estate or the employee's beneficiaries will then be required to compute income under the same rules that the employee would have used had he continued to live but sold the stock upon the date of death. To the extent that an estate tax is paid upon such income, the estate or heirs will be entitled to a deduction for such estate tax.

Health and Accident Plans (*Sections 104, 105, 106*)

Under the former Code if an employer purchased group health and accident insurance, the premiums paid for such policies did not constitute income to the employees. How-

ever, if such an employer purchased individual accident and health policies for employees, the premiums for these policies were considered taxable income. The new Code removes this inequity, and provides that such premiums do not constitute taxable income to the employees regardless of whether group or individual policies are involved and irrespective of whether the plan is administered by the purchase of insurance policies or by contributions to a self-administered fund.

Amounts received by employees as reimbursements for medical care or as payments for permanent injury are not includable in taxable income. In the event an employee who is ill continues to receive wages, or payments in lieu of wages, the first $100 per week of such payments do not constitute taxable income. If an employee is confined to a hospital for at least one day during his illness, he may exclude wages applicable to the first and succeeding weeks. If, however, he is not hospitalized he may exclude wages only for the second and succeeding weeks of illness.

Section 105 provides that these benefits shall be available to employees if paid under "accident and health plans." The statute contains no definition of the word "plan" but it is expected that it will be necessary to satisfy the Commissioner in each individual case that an employer has an actual plan. Although the regulations will probably provide that the existence or nonexistence of a plan is a question of fact which must be determined in each individual case, it is probable that where an employer for a period of time has consistently paid wages to employees who are ill he will be deemed to have a plan.

Death Benefits (*Section 101*)

The general rule that life insurance proceeds payable solely by reason of death of the insured are exempt from income tax has been continued in the new Code. Under the 1939 Code if insurance contracts were transferred for a valuable consideration, the income tax exemption relating to the proceeds applied only to the consideration which was paid for the contract, plus the amount of premiums paid thereafter by the transferee. This limitation of the exemption did not apply where the transfer was of such a nature that the transferee was required to use the transferor's basis. This latter provision has been extended so that the proceeds of contracts transferred either to the insured's partner, a partnership of which the insured was a partner, or to a corporation in which the insured was a shareholder or officer will no longer be partially taxable.

The 1939 Code provided that the first $5,000 of death benefits received by an employee's estate or beneficiary pursuant to an employment contract did not constitute taxable income to the estate of the

beneficiary. This rule has been altered to provide, first that an employee has only one $5,000 exemption regardless of the number of employers; second, that voluntary payments by an employer will now qualify; and third, amounts as to which the employee has a nonforfeitable right to receive while living shall not qualify. The foregoing and various other rules of somewhat lesser importance apply to amounts received by reason of the death of an employee after August 16, 1954.

The 1939 Code provided that proceeds of life insurance paid in installments were exempt from income even though a portion of each payment actually constituted interest. Under the new law such interest income is taxable except that a widow receiving such proceeds is entitled to an exclusion of $1,000 per year.

Estate Tax on Life Insurance (*Section 2042*)

A major change has been made in the new law regarding the excludability for estate tax purposes of insurance upon the life of the deceased. Insurance proceeds payable to the Executor or the Estate are subject to estate tax as before. Under prior law insurance proceeds receivable by others than the Executor or the Estate were includable in the taxpayer's estate if the deceased either had incidents of ownership in the policies or paid the premiums directly or indirectly. Under the new Code the payment of premium test has been eliminated and insurance upon the deceased's life will be includable in his estate only if he retained at the date of his death any of the incidents of ownership in the policy which he could exercise either alone or with any other person. Unlike the old law, section 2042 provides that a reversionary interest will constitute an incident of ownership, if immediately before the death of the decedent the value of the reversion was more than 5% of the value of the policy. It is immaterial whether the reversion is expressed or merely exists by operation of law.

Partnerships

By John McCullough

This paper will be divided into two parts—the first will be devoted to a short statement of the principles which were not modified by the 1954 Code and the second to the new rules in the Internal Revenue Code of 1954. Many of the new rules simply constitute an express statement of the principles which were developed by litigation, regulation or administrative procedure and are, in no sense, a change in the law.

PART I

Rules Not Affected by the 1954 Code

The following principles which were applicable under the 1939 Code are expressly followed or adopted by the 1954 Code:

1. The same broad definition of a partnership. (Section 761(a).)
2. The partnership is a tax-reporting entity and not a taxpaying entity. (Section 701.)
3. Elections affecting the computation of taxable income will be made by the partnership except those relating to foreign and U. S. possession taxes. (Section 703(b).) This was generally held to be the rule under the 1939 Code.
4. A family partnership will be recognized to the same extent as under prior law. (Section 704(e).)
5. A partner shall report his distributive share of partnership income, deductions and credits for the taxable year of the partnership ending within or with his taxable year. (Section 706(a).)
6. No gain or loss is recognized to a partnership or to a partner on the contribution of property to the partnership. (Section 721.)
7. The basis of property contributed to a partnership is the same as it was in the hands of contributing partner. (Section 723.) The holding period of the contributor is tacked on to that of the partnership. (Section 1223 (2).)
8. No gain or loss shall be recognized to a partnership on a distribution of money or property to a partner. (Section 731(b).)
9. Gain or loss on the sale of a partnership interest shall be treated as capital gain or loss except that the 1954 Code changes the law as to the amounts attributable to unrealized receivables and appreciated inventories. (Section 741.)
10. The basis of the interest of a partner in a partnership shall in the first instance be determined by reference to the general rules applicable to basis. (Section 742.)
11. Certain payments made to a successor in interest of a deceased partner to the extent that they are includible in gross income of the recipient shall be considered as income against which the estate tax thereon is allowed as a deduction. (Section 753.) The 1954 Code clarifies and expands the 1939 Code in this respect. The new provision is applicable to payments made in respect of decedents dying after December 31, 1954. (Section 771(b) (4).)

PART II

New Rules Established by the Internal Revenue Code of 1954

The Internal Revenue Code of 1954 devotes an entire subchapter containing 27 sections entitled Subchapter K, Partners and Partnerships, to the subject, in contrast to the 9 sketchy provisions included in the Internal Revenue Code of 1939.

Effective Dates: Particular attention must be devoted to effective dates so that the appropriate rule will be applied in determining the tax effect of each transaction. The new rules are, in general, applicable to any partnership taxable year beginning after December 31, 1954 and any part of a partner's taxable year falling within such partnership taxable year (section 771(a)(1)). Specific dates are made applicable to certain rules and in certain cases taxpayers are given the option to apply the new rules to years beginning after December 31, 1953 and before January 1, 1955 (section 771(c)). These specific effective dates will be referred to in the discussion of the applicable rules.

Character of Items Constituting Distributive Shares: Recent decisions relating to prior law hold that the conduit theory is not applicable to partnerships in the transfer of certain items of income and deduction from the partnership to the partner. Thus, for example, if a partnership suffered a fully deductible loss on the sale of a section 117(j) asset, the partner would not be required to offset his distributive share of such fully deductible loss against his personal capital gains. The 1954 Code expressly requires conduit treatment for a number of major items, such as capital gains and losses, items formerly classified under section 117(j) (now section 1231), contributions, dividends, tax-exempt interest and foreign taxes. The treatment of other items is left to the regulations (section 702(a)(8)). The conduit theory is also followed by providing that a partner's gross income shall include his share of the gross income of the partnership (section 702(c)). This may be important in determining applicability, for example, of the six-year statute of limitations where there has been an omission of gross income, of the provisions relating to the requirement for filing returns, personal holding company classification, in case of a corporate partner, and back pay for prior years.

Partner's Distributive Share: The distributive share of each partner in any item shall be determined by reference to the partnership agreement (section 704(a)). If the partnership agreement is silent as to any item or if the principal purpose of a distributive provision is the avoidance or evasion of any tax, it shall be determined in accordance with his distributive share of the part-

nership income or loss. (Section 704(b).) Where property is contributed to the partnership, there may be a difference between the fair market value on the date of the contribution and the tax basis. The new rule provides that, unless the partnership agreement provides differently, the property shall be treated in the allocation of depreciation or gain or loss among the partners as if it had been purchased by the partnership. (Section 704 (c)(1).) Partnerships which have this situation would be well advised to reduce their agreement on this subject to writing. In drafting any partnership agreement, consideration should be given to the incorporation of such a provision relating to after-acquired property (section 704 (c)(2)). The partnership agreement, by statutory definition, includes any modifications thereof made prior to, or at the time prescribed by law for the filing of the partnership return. However, the time does not include the period of any extension and the agreement must be signed by all the partners or must be adopted in such other manner as may be provided by the agreement. (Section 761(c).) The Senate Finance Committee Report indicates that modifications may be made orally.

Limitation on Partner's Distributive Share of Loss: A partner may deduct his distributive share of the partnership loss only to the extent of the basis of his interest in the partnership as at the close of the partnership taxable year. He may deduct any excess of such loss over his basis at the end of the partnership year in which such excess is repaid. Prior law contained no express limitation on such losses. A partner may derive some tax advantage from a judicious selection of the taxable year in which to make repayment. (Section 704(d).)

Certain Unrealized Receivables and Substantially Appreciated Inventory Items: The new law sets up elaborate rules to deny capital gain treatment to realization of income on a sale or disposition involving certain unrealized receivables and substantially appreciated inventory items.

The term "unrealized receivables" includes any rights to payment for goods other than capital assets or for services rendered or to be rendered which were not previously includible in gross income by the partnership. The term would apply in most instances to partnerships on a cash basis and only to accrual-basis partnerships in those instances where the claim was not accruable in accordance with generally accepted principles of accrual accounting. (Section 751(c).)

The term "substantially appreciated inventory" means the following items which have appreciated in value so that their fair market value exceeds, first, 120 percent of the adjusted basis to the partner-

ship, and second, 10 percent of the fair market value of all partnership property other than money. (Section 751(d)(1)):

1. Property of a kind usually included in inventory. (Section 751(d) (2) (A).)
2. Property which is not a capital asset or which is not treated as a capital asset. (Section 751(d) (2) (B).)
3. Property held by the partnership which would be of the type described in the preceding paragraphs, if held by the partners. (Section 751(d) (2) (C).)

The Senate Finance Committee Report seems to indicate that the term inventory items refers to the entire inventory of stock in trade.

For ease of reference these receivables and inventory items will hereafter be referred to as stated receivables and inventories.

Under prior law, there was no express denial of capital gain treatment to the realization of the income included in the stated receivables and inventories. Such income might be realized through the consummation of any of the following transactions:

1. The partner might sell or exchange his interest in the partnership, the value of which might be enhanced by ordinary income included in the stated receivables and inventories and not previously reported. He would pay a capital gains tax on the enhancement in value. The new law expressly bars capital gain treatment to such gain. By the same token, if the transaction should result in a loss applicable to the stated items, it would be allowed as a fully deductible ordinary loss (section 751(a)).

Such ordinary gain or loss is determined by deducting the tax basis of the stated receivables and inventories from the selling price thereof. The Senate Finance Committee Report states that the tax basis of the stated receivables and inventories is to be prescribed by regulations, but indicates that it will be the prorata share of the basis in the hands of the partnership but not to exceed, however, the basis of the partnership interest in the hands of the partner. Such part of the basis allocated to the stated receivables and inventories will be deducted from the basis of the partnership interest in determining the capital gain or loss on the sale of the remaining part of the partnership interest. The selling price is that part of the entire selling price which is attributable to the stated receivables and inventories (section 751(a)).

2. Another transaction whereby a partner might realize the unreported income included in the stated receivables and inventories would be their distribution by the partnership to a partner who would thereafter sell them and report capital gain on the ground that in his hands such items were capital assets. The new law also bars capital gain treatment in this type of transaction. This result is achieved by providing that gain or loss on the disposition

by a distributee partner of the unrealized receivables and all inventory items, whether or not appreciated, shall be considered as gain or loss from the sale or exchange of property other than a capital asset. (Section 735(a)(1) and (2).) However, in the case of inventories, the rule will apply only if sold within the period of five years from the date of distribution not including, however, in such period the technical holding period of the partnership. (Section 735(b).) This rule shall apply only to property distributed by a partnership after March 9, 1954 (section 771(b)(2)). However, partnerships are given the option to apply the new rule to taxable years beginning after December 31, 1953 and before January 1, 1955, except as to distributions in complete liquidation (section 771(c)).

3. Another transaction whereby a partner might realize upon the stated receivables and inventories would be the disproportionate distribution of partnership property in exchange for all or part of his interest in the partnership. The new law provides that regulations are to be prescribed outlining the rules to be followed on the theory that these items were exchanged by the parties for other partnership property. This would result in ordinary gain or loss rather than capital gain or loss to the partner to the extent that he disposed of more than his share of the stated receivables and inventories, and to the partnership to the extent that it distributed to the partner more than his share of those assets. (Section 751(b)(1).) However, this provision does not apply to the distribution of property contributed to the partnership by the distributee partner nor to payments made for unrealized receivables to a retiring partner or successor in interest of a deceased partner. (Section 751(b)(2).) These new rules are effective as to distributions occurring after March 9, 1954. Except as to distributions in complete liquidation, the partnership may elect to apply the new rule as to taxable years beginning after December 31, 1953 and before January 1, 1955.

Determination of Basis of Partner's Interest: Unlike the 1939 Code, the new law sets forth elaborate rules for the calculation of the tax basis of the interest of the partner in the partnership. The calculation of this amount is important because it is a factor in the determination of (1) the gain or loss on the sale of the interest or on the receipt of a certain distribution from the partnership, and (2) the basis in the hands of a partner of property distributed to the partner by the partnership.

In the first instance, the general rules relating to the determination of basis are to be employed where an interest is acquired other than by contribution (section 742). If acquired by contribution, the basis

is to be increased by the amount of money and the adjusted basis of the property to the contributing partner at the time of the contribution (section 722). The arithmetic addition and deduction of normally recurring items such as net income, net loss, etc., to and from the basis are also expressly provided for (section 705). The general rules are for the most part a codification of rules followed administratively in practice. The codification puts to rest, however, one troublesome question. Under the new rules, it is clear that the selling partner is taxable on his distributive share of the partnership income for the taxable year which is closed as at the date of sale under another section (section 706 (1) (2)). This has the effect of denying capital gain treatment to current undistributed income. Some courts allowed capital gain treatment to such items under prior law. Other sections provide elaborate rules for the determination of the amount to be applied in reduction of the basis of the partner's interest resulting from a distribution of property to a partner not in complete liquidation. The basis of the partnership interest must be reduced on account of such distributions in accordance with the following rules:

1. The amount of any money.
2. The basis in the hands of the distributee partner of the distributed property (section 733) which will vary as set forth in section 732 with the facts. This subject is discussed under the next topical heading.

Any increase in a partner's share of partnership liabilities or any individual assumption of partnership liabilities shall be considered as money paid in to the partnership and conversely any decreases shall be treated as distributions of money by the partnership (section 752).

Where liabilities exceed the capital accounts and a new partner is admitted who assumes a share of such liabilities, it is possible that the old partners may realize gain on the theory that they received cash distributions in excess of the tax basis of their interest in the partnership. Until the Regulations clarify this point, care should be exercised on the admission of new partners to avoid the realization of gain in such instances.

The Treasury is empowered to prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership (section 705(b)).

The partnership is given the option of electing to apply the foregoing rules to taxable years beginning after December 31, 1953 and before January 1, 1955. (Section 771(c).)

Basis of Distributed Property in Nonliquidating Distributions in Hands of Distributee Partner: Under prior law, a partner was required in general to allocate a proportionate part of the basis of his partnership interest to the distributed property. The new law sets up the following rules for this purpose:

1. In general, the property will take the same basis as it had in the hands of the partnership (section 732(a) (1)), but this basis must in no event exceed the basis of his interest in the partnership (section 732(a) (2)).
2. Where a partner has acquired an interest in a partnership through purchase or death at a tax basis which is greater or less than his prorata share of the adjusted basis of the assets in the hands of the partnership, the partnership is granted an election to make corresponding adjustments to the basis of the property in the hands of the partnership. Even though such an election was not made, the transferee partner may elect to treat the basis of the property as though the election had been made provided the distribution was made within two years of the transfer. The Treasury may by regulation require such an adjustment regardless of the date of the transfer if the fair market value of the property received by him exceeds 110 per cent of its adjusted basis to the partnership at the time of the transfer of the partnership interest (section 732(d)).
3. Specific rules already discussed apply where the partnership makes a disproportionate distribution involving stated receivables and inventories (section 732(e)).
4. The basis to the distributee partner of unrealized receivables and all inventory items, whether or not appreciated, is the same as it was in the hands of the partnership, unless the basis of the partnership interest, reduced by any cash distribution, was less than such partnership basis. In that event, such partnership bases shall be reduced to the basis of the partner's interest in proportion to such partnership bases. Priority is accorded to these items in the allocation of basis (section 732(c)).

The partnership is given the option of electing to apply the foregoing rules with the exception of the second to taxable years beginning after December 31, 1953 and before January 1, 1955 (section 771(c)).

Holding Period of Property Distributed in Kind: The new law specifies that, in the case of distributions in kind, except for appreciated inventory, the partner may tack on to his own holding period the period the property was held by the partnership (section 735(b)).

Importance of Timing Distributions in Kind: No distribution of partnership property in kind or the sale of partnership interests should be consummated without careful advance planning of the timing of the transactions. This statement can perhaps be illustrated most effectively by examples.

Example 1: Let us assume that partner X purchased a 75 per cent interest in the AB partnership from B for $75,000 when the balance sheet of the AB partnership indicated the following:

	Assets			*Capital*	
	Adjusted Basis	*Market Value*		*Adjusted Basis*	*Market Value*
Cash	$ 5,000	$ 5,000	A	$ 37,500	$ 25,000
Accounts receivable	45,000	45,000	X	112,500	75,000
Depreciable property	100,000	50,000			
	$150,000	$100,000	Total	$150,000	$100,000

The AB partnership and both partners report on the calendar year basis and they elect to apply the provisions of the 1954 Code. The AB partnership distributes the depreciable property in partial liquidation to X who operates it in his business and after a certain period he sells it. Under section 732(a)(2), the basis, disregarding the adjustment for depreciation, is $75,000, the basis of his entire interest in the partnership. Assuming no change in the market, he would sell it at its fair market value of $50,000 and assuming he had no gains from the sale of similar property, he would have a fully deductible loss of $25,000.

Later, he sells out his partnership interest, the basis of which has now been reduced to zero by virtue of section 733(2). Assuming no change in the market value of the remaining assets, he would sell his half interest in the partnership for $25,000 which he would report at capital gain rates in accordance with section 741.

Assuming the same set of facts, except that market values and adjusted bases are substituted for each other, X would have capital gain and possibly ordinary gain of $50,000 and a capital loss of the same amount. However, this result would be changed to a gain of $12,500 and a loss of the same amount by the partnership election to increase the basis of the assets under section 743. This possibility should be borne in mind in deciding whether to elect to increase the basis.

If X had surrendered his entire interest in exchange for a prorata distribution, he would have had neither gain nor loss upon the distribution.

Example 2. Let us assume the same basic facts as they existed in the preceding example following the purchase of the interest by X. The assets are distributed prorata in complete liquidation to A and X. Neither A nor X is entitled to any loss on the liquidation since property other than money is included in the distribution in complete liquidation. When the assets are sold, presumably at their fair market value, by A and X, A will have a

capital or ordinary loss deduction of $12,500 and X will have no deduction because he will simply recover his basis.

However, let us assume that the AB partnership collects its receivables, sells the depreciable property at its fair market value for cash, and distributes the cash which is its sole asset in complete liquidation. The partnership has an ordinary loss deduction of $50,000 which is charged $12,500 to A and $37,500 to X, since the partnership does not elect to reduce the basis of its assets by virtue of the transfer to X. The foregoing loss deduction reduces the basis of the partnership interest of A and X to $25,000 and $37,500, respectively, in accordance with section 705. When cash of $100,000 is distributed to A and X in the respective amounts of $25,000 and $75,000, A will have neither gain nor loss and X will have a capital gain of $37,500. The position of A is improved because his loss will clearly be ordinary and X obtains a tax advantage equal to excess of the reduction in tax by virtue of the ordinary loss deduction of $37,500 over the capital gains tax. In example 1, A's loss is a capital loss and X's corresponding advantage is reduced to the tax differential based upon $25,000.

Other examples which further exaggerate the effect of timing could be developed. The point is that all possibilities of sale and distribution should be explored before decision is made as to the ultimate choice.

It is entirely possible that Congress will change these rules in 1955.

Appreciated Inventory and Distributions in Kind: No distributions in kind should be made without consideration of the effect which they might have on undistributed substantially appreciated inventories. If such a distribution is made, it might have the effect of converting ordinary inventory to substantially appreciated inventory since one of the tests is that the fair market value of the inventory must exceed 10 per cent of the fair market value of all partnership property other than money. Conversely, a distribution in kind of part of the inventory may minimize the burden arising from the qualification of inventory as being substantially appreciated.

Similarly, the conversion of other assets to cash, as, for example, by way of sales and leasebacks, should also be considered for their effect on the classification of appreciated inventory.

This factor should also be borne in mind in the case of problems involving additional property. It may be advisable to purchase rather than lease and it may be advisable to decide in favor of expansion of the business by addition of other assets.

Partnership's and Partner's Taxable Years: A partnership may not change to, or adopt, a taxable year

other than that of all its principal partners unless it establishes a business purpose therefor to the satisfaction of the Treasury. A principal partner may not change to a taxable year other than that of his partnership unless he establishes a business purpose therefor to the satisfaction of the Treasury. A principal partner is one having an interest of 5 per cent or more in partnership profits or capital. (Section 706(b) (3).) These rules are applicable to any partnership which adopts, or changes to, a taxable year beginning after April 1, 1954 and to any partner who changes to a taxable year beginning after April 1, 1954. (Section 771(b) (1).)

Closing of Partnership Taxable Year: A troublesome question under prior law was the effect which the death of a partner, the entry of a new partner, the liquidation of a partner's interest and the sale or exchange of a partner's interest had upon the taxable year of the partnership, first, as to the continuing partners and, second, as to the withdrawing or deceased partner. Under the new law, as to the continuing partners, the partnership's taxable year does not close. As to a partner who sells or exchanges his entire interest or whose interest is entirely liquidated, the partnership's taxable year closes. However, the year shall not close with the death of a partner. (Section 706(c).)

The foregoing rules apply only if the partnerhip is not terminated. Termination is defined as complete cessation of the business or as a sale of an interest of 50 per cent or more in partnership capital or profits within a 12-month period. (Section 708(b) (1).)

Mergers, Consolidations and Divisions: If the members of the old partnership own an interest of 50 per cent or more in the new merged or consolidated partnership, then the new partnership shall be a continuation of the old. The significance of this is that the old partnership is not terminated, so that among other things, its fiscal year is not affected. In the case of a division, a similar rule is followed. (Section 708(b) (2).)

Transactions Between Partner and Partnership: Another troublesome question under prior law was the treatment to be accorded to transactions between partners and their partnerships. The new law provides that the transaction shall be considered as occurring between the partnership and a nonpartner with the following exceptions (section 707(a)):

1. No loss will be allowed on the sale of property between a partnership and a partner owning directly or indirectly more than 50 per cent of the capital or profits interest in such partnership or between two partnerships in which the same persons own, directly or indirectly

more than 80 per cent of the capital or profits interest. (Section 707(b) (1).)

2. Capital gain treatment will not be accorded to gain on sale or exchange of property which is not a capital asset in the hands of a transferee, when the transaction is between a partnership and a partner owning, directly or indirectly, more than 80 per cent of the capital or profits interest or between two partnerships in which the same persons own, directly or indirectly, more than 80 per cent of the capital or profits interest. (Section 707(b) (2).)

Under prior law, salaries and interest payable to partners were, in general, not treated as deductions but were considered as distributive shares of net income. The new law states that where these amounts, designated as guaranteed payments, are payable regardless of net income, they are treated as though made to a nonpartner. (Section 707(c).)

Extent of Recognition of Gain or Loss on Distributions: The old law followed the rule that gain or loss would be recognized to a distributee partner only on the receipt of money differing from the basis of the distributee partner's interest. The gain or loss was not considered to be capital gain or loss. Under the new law, gains or losses determined in accordance with the following rules are treated as capital gains or losses.

1. Whether the distribution is in liquidation or not, gain will be recognized only to the extent that money exceeds the basis of the distributee partner's interest. (Section 731(a) (1).)
2. On distributions in complete liquidation only, loss will be recognized to the extent that the basis of the distributee partner's interest exceeds the sum of the following items:
   - A. The amount of money.
   - B. The basis to the partner of unrealized receivables and all inventory items, whether or not appreciated, previously discussed. (Section 731(a) (2).)

Except as to distributions in complete liquidation, partnerships are given the option of applying the new rules to taxable years beginning after December 31, 1953 and before January 1, 1955.

Optional Adjustment to Basis of Partnership Property: Under prior law there was, in general, no means of correlating the tax basis of the net assets in the hands of the partnership with the aggregate of the bases of the partnership interests in the hands of the individual partners. Variations could occur when one partner sold his interest to a transferee partner at a gain or loss or when one partner died leaving his interest to a transferee estate which carried its interest at a tax basis equal to the fair market value determined for estate tax purposes. These variations could be aggravated by distributions in partial liquidations. The new law provides rules for the optional adjustment of the basis of property in the hands of the partnership which will tend to eliminate the aforementioned discrepancy. The part-

nership may make the adjustment to the basis of its properties if it makes such election in accordance with forthcoming regulations. The election will apply to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent years. The election may be revoked by the partnership subject to limitations prescribed by the Regulations (section 754).

Detailed rules are prescribed for the allocation of the adjustment among the various assets. In general, these rules require (1) that the adjustment be applied in such a manner that the difference between fair market value and basis shall be reduced and (2) adjustments be divided into two classes, first, capital assets and assets used in the trade or business (formerly section 117(j) assets, now section 1231) and second, other assets normally current assets such as accounts receivable and inventories. Adjustments attributable to one class cannot be made to those in another class. If there are no assets or assets with insufficient basis, the adjustment is made to the extent of available basis and the remainder is carried forward until appropriate assets are subsequently acquired. There is apparently no prohibition against allocating an adjustment arising from a capital asset to a section 117(j), now section 1231, asset; thus, a capital asset with a partnership tax basis of $57,000 is transferred to a partner with a basis of $1,000 for his interest in the partnership. The partnership could allocate this $56,000 to section 117(j) assets assuming it had no remaining capital assets.

In the case of a transferee partner or estate of a deceased partner, the increase is equal to the excess of the basis of his partnership interest (increased by his prorata share of the liabilities) over his proportionate share of the adjusted basis of the property in the hands of the partnership. A corresponding decrease is made in the converse situation. The adjustment is made with respect to the transferee partner only. (Section 743.)

In the case of distributions of property to the partners, gain or loss may, as already indicated, be recognized to the partner. The basis of the property in the hands of the partnership may be increased by the gain or decreased by the loss. (Section 734(b)(1)(A) or (b)(2)(A).) On distributions of property other than money, the basis of the partnership property may be increased by the excess of the adjusted basis of the property in the hands of the partnership over the basis of the distributed property in the hands of the distributee partner. (Section 734(b)(1)(B).) Conversely, the law provides that the basis may be decreased by the excess of the basis of the distributed property in the

hands of the distributee partner over the adjusted basis of the property in the hands of the partnership (section 734(b)(2)(B).

It is difficult to conceive of many situations where any partnership should elect to reduce the basis of its assets either in the case of transfers of partnership interests or distributions of partnership property. One situation might occur where a partner might wish to report minimum gain on a distribution in kind and in money. Unless the partnership elected to reduce the basis of the property (say, land), the gain and the basis of the land might be higher than desired by the distributee partner. In other situations, loss on distributions in complete liquidation might be increased with a corresponding reduction in basis of property (say, land) previously distributed not in liquidation.

Nevertheless, these sections become operative in the case of transfers and distributions requiring reduction in basis and following an election in a prior year which resulted in an increase in the basis. The sections relating to reduction of basis in the case of distributions are operative only where distributions are made in complete liquidation of the interest of one partner and not of the partnership.

As already indicated, no sale or distribution should be made without regard to the effect of timing on basis. Similarly, careful consideration should be given to the effect, present and future, of elections to increase basis and to decrease basis arising from transfers of partnership interests and distributions of partnership property. The results produced by the Code are not always in accord with economic realities. The following points should particularly be borne in mind:

1. An election made by a partnership to increase or decrease the basis of its partnership property for one type of transaction, e.g., a transfer, will require adjustment for every type of transaction, e.g., a distribution, regardless of whether that adjustment resulted in an increase or decrease.
2. A transferee partner may elect within two years of a distribution to treat property distributed to him as though the partnership had made the election. This may be advantageous in cases where any election by the partnership may be of no present value to the partnership. Elections to make adjustments do not apply to transfers and distributions made during taxable years ending before those in which the election was made.

Payments to a Retiring Partner or a Deceased Partner's Successor in Interest: Under prior law, the treatment to be accorded payments made to a retiring partner or to the estate of a deceased partner was productive of much litigation. To what extent were the payments to be treated as in payment of capital and therefore to be reported as proceeds from the sale of a capital asset by the recipient and as the purchase of a capital interest by the partnership or continuing partners. To

what extent were the payments to be treated as distributions of current income and therefore to be reported as ordinary income by the recipient and in effect deductible, as such, by the continuing partners.

The new law provides that payments for the following items shall be treated as distributions of current income to the retiring partner or successor in interest of a deceased partner:

1. Payments for unrealized receivables as previously defined. (Section 736(b) (2) (A).)
2. Payments for good will except to the extent that the partnership agreement provides for the payment of good will. (Section 736(b) (2) (B).)
3. Distributive shares to the recipient of partnership income if based on the income of the partnership. (Section 736(a) (1).)
4. Guaranteed payments, previously discussed, for salaries and interest if determined without regard to the income of the partnership. (Section 736(a) (2).)

Payments made in exchange for the interest of such partner in partnership property shall be considered as a distribution by the partnership in accordance with details to be spelled out in forthcoming regulations. (Section 736(b)(1).) To the extent that the payment covers the partner's interest in substantially appreciated inventory as previously defined, the gain will be taxed as ordinary income. The gain or loss on the payments for the remainder of the interest will be capital gain or loss.

Election of Unincorporated Organizations Not To Be Taxed as Partnerships: The new law permits certain unincorporated organizations under forthcoming regulations to elect not to be taxed as partnerships under the following conditions:

1. All the members must so elect.
2. The organization is availed of (1) for investment purposes only and not for the active conduct of a trade or business, or (2) for the joint production, extraction or use of property but not for the purpose of selling services or property produced or extracted.
3. The income of the members of the organization may be adequately determined without the computation of partnership taxable income.

This election enables the members of unincorporated organizations, such as oil ventures, to avoid the necessity of filing partnership returns. However, the election should not be made without consideration of the fact that the use of the partnership may enable the parties to obtain the benefit of elections such as intangible drilling expenses, instalment method, depreciation methods, etc., which are available to new taxpayers but not to themselves individually. This advantage could easily outweigh the cost of preparing a partnership return (section 761(a)).

Election of Proprietorship or Partnership To Be Taxed as Corporation: A proprietorship or a partnership may elect to be taxed as a corporation under the following conditions:

1. The proprietor or all the partners owning an interest in the partnership from the first day of the first applicable taxable year elect, in accordance with forthcoming regulations, not later than 60 days after the close of that taxable year, to be taxed as a domestic corporation. (Section 1361(a).)

2. The election will be irrevocable and will apply to any unincorporated successor and the proprietor or partners of such successor. (Section 1361(e).)

3. If the electing proprietor or partners have an interest of 80 per cent or less in the interest in the profits and capital of the partnership in any year, such enterprise shall not be considered as a domestic corporation for such year or later years unless the new proprietor or new partnership so elects to be taxed. (Section 1361(f).)

4. The corporate taxes are limited to the normal tax, surtax, accumulated earnings tax and the capital gains tax but certain items of personal holding company income and deduction are excluded from the election. (Section 1361(g).)

5. The enterprise must be owned by an individual or a partnership consisting of not more than 50 partners. (Section 1361(b) (1).)

6. No proprietor or partner having more than a 10 per cent interest in profits or capital of such enterprise is a proprietor or partner having more than a 10 per cent interest in profits or capital of another enterprise taxable as a corporation. (Section 1361(b) (2).)

7. No proprietor or partner is a nonresident alien or a foreign partnership. (Section 1361(b) (3).)

8. The enterprise is one in which capital is a material income-producing factor or 50 per cent or more of its gross income consists of gains from trading as a principal or from buying and selling real property, securities or commodities for the account of others. (Section 1361(b) (4).)

9. Various technical provisions are made for applying corporate rules to the enterprise. (Section 1361(j), (k), (l) and (m).)

Summary of Salient Points

1. The family partnership is still a good vehicle for reducing over-all family income in appropriate cases. Agreement should provide for compensation to parent. Capital must be an income-producing factor and the partnership cannot be used as a device for spreading earnings among the members of the family.

2. Personal holding company rules have been relaxed so that it is now possible in many cases to lease partnership property to a real estate corporation owned by the partners. If the real estate corporation has no other personal holding company income, it will not be subject to the surtax on personal holding companies and if its net income is less than $25,000, it will not be subject to the surtax.

3. Under the 1954 Code, it is important that partnership agree-

ments be reduced to writing, particularly for the following two reasons:

A. Payments to retiring partners for good will will be treated as such and therefore be entitled to capital gain treatment only to the extent provided in the agreement and only if reasonable.

B. Where a new partner contributes property with a fair market value which differs from the tax basis, the discrepancy causes a difference between taxable income and accounting income due to the difference in the basis on which depreciation or gain or loss is computed. Most partnerships allocate such differences entirely to the contributing partner. In order to accomplish this, the partnership agreement must so provide.

4. Under the 1954 Code, gains on distributions in liquidation of a partner's interest are capital gains, not ordinary gain. Under prior law such gains were ordinary gains. Hence, partners receiving such distributions in partial liquidation in 1954 should elect to apply the provisions of the 1954 Code. If a partner anticipates a gain on complete liquidation of his interest, he should postpone retirement until 1955.

5. A partner anticipating a loss on complete liquidation should retire in 1954 when his loss will be fully deductible. Postponement until 1955 will convert the loss from an ordinary one to a capital loss.

6. Under prior law, some courts held that capital gain arose from the sale of a partner's interest which included undistributed and unreported income of the partnership. If such an interest is sold in 1954, there is a chance that such gain will be treated as capital gain particularly in those circuits where favorable decisions may be promulgated. There is no chance for such favorable treatment after 1954 under the 1954 Code.

7. The 1954 Code sets up elaborate rules for the determination of the basis of partnership property in the hands of the partnership and also in the hands of the distributee partner. Rules are also provided for the determination of the basis of the interest of the partner in the partnership. Elections are given to the partnership to increase or decrease the basis of the partnership property and, under certain circumstances, in the case of transfers to a distributee partner. These rules are arbitrary and do not produce results which are in accordance with the economic realities of the situation. No extraordinary sale of partnership property and no distribution of partnership property in kind should be made without calculating the effect of various alternative methods of accomplishing the same result; for example, the effect of having the partnership sell the assets should be compared with the effect of distributing them to one or more of the partners who would make the sale.

8. Under the 1954 Code, the conduit theory is specifically adopted. This means that items of income or deductions retain the same character in the hands of the partner which they had in the hands of the partnership. Thus, capital gains must be offset against capital losses whether realized by the partnership or the partner as an individual. Some courts did not follow this rule under prior law and allowed distributive shares of partnership capital gains to be reported at favorable capital gain rates and full deduction for loss on sale of section 117(j) assets suffered by the partner individually. This favorable treatment will no longer be allowed after 1954.

Federal Estate and Gift Taxes

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FEDERAL ESTATE TAX

There are only two changes made by the 1954 Code in the federal estate tax provisions which can be considered to have wide applicability. They relate to the inclusion of certain proceeds of insurance policies and employees' annuities in the decedent's gross estate.

There also are certain *minor* changes in the estate tax provisions. These will have but limited application.

All the 1954 changes in the estate tax provisions are hereinafter discussed.

Insurance. The first change of general interest pertains to the inclusion of the proceeds of decedent's life insurance in his gross estate where such proceeds are payable to persons other than the estate.

Under former law, the proceeds of insurance on a decedent's life were taxable if and to the extent the decedent had paid the premiums on such insurance. The amount included in his taxable estate was a portion of the proceeds based on the proportion of the total premiums that had been paid by him.

Under the 1954 Code, if the decedent has no incidents of ownership at his death, either alone or in conjunction with another person, the proceeds of life insurance are *not* included in his taxable estate, even though he paid the premiums. The incidents of ownership, as under the old law, are not generally defined in the Code, but the new Code *does* expressly provide that a reversionary interest which exceeds 5 per cent of the value of the policy immediately before death is an incident of ownership.

The exclusion from the taxable estate, of insurance on which the decedent has paid the premiums, offers opportunities for estate planning through the lifetime transfer or relinquishment by a taxpayer to his chosen beneficiary of the incidents of ownership. There will, of course, be a gift tax on such a transfer. However, the gift tax is at lower rates than the estate tax. Value will approximate the cash surrender value of the policies at the time of the gift. This can result in a considerable tax saving. If the insured person still continues to pay the premiums, there may be further gift tax, if the amount of premium payment exceeds $3,000 per year or $6,000 per year in the case of a married person.

Annuities. The second change in federal estate taxes which has wide

applicability is in the taxation of a deceased employee's annuities.

Under the 1939 Code, payments with respect to annuities were taxed under the general provisions of the federal estate tax. It was generally held that payments received by a surviving beneficiary under the decedent's annuity contract were includible in the decedent's gross estate if the decedent had the right to receive or designate who should receive any payments made upon his death. Joint and survivor annuities were taxed under these provisions at the value of the survivor's interest upon the death of one beneficiary. The value of the payments to the surviving beneficiary thus were taxed in full whether or not the payment was from a qualified pension, profit-sharing or stock bonus plan.

Under the new Code, it is specifically provided that any payment receivable under a decedent's annuity contract or similar agreement (entered into after March 3, 1931) by any beneficiary who must survive the decedent to receive it, is includible in the decedent's gross estate. The right to receive a lump-sum payment thus is also included. The Senate Finance Committee Report states that this section does not apply to proceeds of insurance on the life of the decedent to which the insurance provisions mentioned hereinbefore apply.

However, under the 1954 Code, only such part of the payment to a beneficiary with respect to a decedent's annuity, which is attributable to the part of the purchase price paid by the decedent is to be included in his gross estate. The important change lies in that the part of the purchase price paid by the decedent does not include contributions made by his employer to the purchase of the annuity when the contributions of the employer are made to a qualified pension, stock bonus or profit-sharing plan. Thus, most payments to beneficiaries of deceased employees from qualified pension plans are no longer subject to estate tax.

Of course, the employee's *own* contributions to a qualified plan are regarded as his contributions toward the purchase price; and when the contributions of an employer are made to a nonqualified plan, they are regarded as contributions of the employee.

If the amounts payable with respect to the annuity at the death of the employee are paid to the estate or the executor of the deceased employee rather than to a specified survivor, the contributions of the employer to a qualified plan are regarded as being made by the deceased employee. Thus, the payments would be taxable.

It therefore is most advisable to designate a beneficiary other than the executor or the estate, in order to remove the annuity payments from a taxable category.

Transfers Taking Effect at Death. The problems arising under the *Church* and *Spiegel* cases* relating to transfers taking effect at death, have been subjected to a succession of changes by the courts, regulations and legislative enactments. The 1954 Code again changes the rules with a somewhat liberalizing effect.

Under the 1939 Code, transfers after October 8, 1949 by a decedent, taking effect at death, were includible in his gross estate, even though he retained no reversionary interest, if the possession and enjoyment of the property could be obtained by merely surviving the decedent. For example, property previously transferred to a trust by a decedent, under which the income was to be accumulated during his lifetime and, together with principal, distributed to his son at the father's death, would have been taxable under the former rule, even if the father had no reversionary interest.

The 1954 Code does not subject such a transfer to tax. The new Code provides that transfers by the decedent, taking effect at death, made after October 8, 1949, shall be included in his gross estate only if: (1) the recipient must survive the decedent in order to obtain the properties, and (2) the decedent has retained by will, or other instrument, or by operation of law, a reversionary interest of over 5 per cent of the value of the property transferred.

Deductions. The deduction for funeral expenses, administration expenses, and claims against the estate, and unpaid mortgages is no longer limited to the value of the property subject to the claims and included in the gross estate. However, such expenses and claims are now completely deductible if they are paid before the filing of the estate tax return.

Another new deduction is allowed for expenses incurred in administering property not subject to claims of the estate but included in the gross estate for federal estate tax purposes. These expenses must be paid prior to the expiration of the statute of limitations (generally three years from date of filing return) to qualify as a deduction.

A charitable deduction is now allowed in the case of transfers to veterans' organizations incorporated by Acts of Congress.

Marital Deduction. In the determination of property qualifying for the marital deduction under the 1954 Code, legal life estates are now treated in the same manner as life interests in trusts. Thus, if they are accompanied by a power of appointment of the principal, they qualify for inclusion in the marital deduction. A life interest in income from a specific portion of property

**Church*, 335 U. S. 632, reh. den. 336 U. S. 915; *Spiegel*, 335 U. S. 701, reh. den. 336 U. S. 915.

with power to appoint this specific portion resting in the surviving spouse also now qualifies for the marital deduction.

Proceeds of life insurance, endowment, or annuity contracts if payable in installments or held under agreement to pay interest, and such installments or interest begin not later than 13 months after death, qualify for the marital deduction with respect to any specific portion payable to the surviving spouse, if the spouse has the power to appoint such specific portion.

The other rules as to terminable interests apply as under the old Code. However, under the new Code it is expressly provided that if termination of the interest of the surviving spouse *does not in fact occur* if such spouse dies within six months or in a common disaster with the decedent, the interest will not be a terminable interest. It thus will be includible in the marital deduction. Also, for purposes of the marital deduction, separate property converted from community property after December 31, 1941, is nevertheless treated as community property. Formerly such conversion had to be made before April 2, 1948.

Computation of Tax and Credits Against the Tax. Although there has been no change in the effective tax rate, the method of computation of the federal estate tax has been greatly simplified. The former concept of basic tax and tentative tax has been eliminated. There is now a *single* schedule of rates which is applied to the "taxable estate."

The term "taxable estate" now takes the place of "net estate."

The credit for state death taxes is now expressed as a percentage in a schedule of rates which is also applied to the taxable estate.

The credit for gift taxes previously paid by the decedent on property included in the gross estate under section 319 of the Revenue Act of 1924 is now a credit against the full tax instead of a credit against only the basic tax.

Gift tax paid by the decedent on property included in the gross estate under other revenue laws is the same as before and is a credit against the full tax.

The deduction for property previously taxed has been changed to a credit against the tax. The 1939 Code provided for a deduction from the gross estate for the value of property which was received from persons who paid an estate *or* gift tax on it within five years of death. This has been changed under the 1954 Code into a *credit* against the current federal estate tax for the previous *estate* tax paid on the property. (Credit for gift tax paid by a donor on property previously given to the decedent is not allowed.) The amount of such credit is the estate tax paid on the same property in the previous decedent's estate. It is allowed only with

respect to estate tax paid in the estates of persons dying ten years before or two years after the present decedent. Tracing of property under former law has been eliminated by basing the credit on the value of the property included in the estate of the prior decedent.

The credit is generally computed by taking that portion of the prior estate tax that the value in the previous estate of the property transferred bears to the previous taxable estate plus exemptions and minus death taxes in that estate. The credit is reduced 20 per cent for each of two full years occurring in the period between deaths. The credit is limited to the increase in present estate tax by reason of including the transferred property. There are other adjustments to be made in cases of charitable deductions and where there is more than one prior decedent.

The over-all effect of this provision is to subject the property to the full rates of tax only once where the property is taxed in the estate of two or more decedents who die within a ten-year period.

Estates of Nonresidents Who Are Not Citizens. Certain conforming changes have been made with respect to the taxation of estates of nonresidents who are not citizens, such as the deduction for property previously taxed being converted into a credit against the tax.

Two other changes have been made in the taxation of the estates of these persons. There is no credit for state death taxes if the estate does not exceed $40,000. Previously, the credit was allowed with respect to *all* property included in the gross estate and subjected to state death taxes.

The other change is that a certificate of stock in a foreign corporation is not property within the United States, even if the certificate is located in the United States at the time of death. Previously, such a certificate located in the United States would have been regarded as property within the United States.

Effective Date. The estate tax provisions of the 1954 Code are effective with respect to estates of persons dying after August 16, 1954, the date of enactment. There is an exception to this rule in that in the case of payments to a beneficiary of a qualified employees' trust, the applicable provisions are effective for persons dying after December 31, 1953.

GIFT TAX

Generally, the gift tax has not been substantially changed. Of the changes made, the most important changes have been made with respect to certain transfers between husbands and wives. The new gift tax provisions of the 1954 Code are effective for the calendar year 1955 and thereafter.

Transfers Between Husband and Wife. Under the 1939 Code which is still effective for a few months, property purchased in the name of husband and wife or placed in both names if the property was previously owned by one of the parties, is subjected to gift tax on the full value of the property at the time of the gift, less the present worth of the retained rights of the spouse who supplied the consideration. The value of the retained rights depends upon the laws of the various states and can be one-half of the income, or all of the income for life and the right to the principal if such spouse survives the other spouse. At termination of such a tenancy other than by death, there may be *another* gift which is subject to tax depending upon the division of the property at such termination of the tenancy.

The 1954 Code provides that the donor spouse may elect to have the transaction treated as under present law. However, if there is no election, the transaction is not subject to gift tax at the time of placing the property in both names. At termination of the tenancy other than by death, however, there is a gift to the extent the portion of the proceeds due to the donor spouse (based on the proportion of the consideration supplied by the spouse) exceeds the amount actually received by such spouse. For example, assume that the husband furnished $30,000 and the wife $10,000 as consideration for the purchase of the property and the property was sold for $60,000, the husband received $35,000 and the wife $25,000. The gift to the wife would be $10,000, computed as follows: The amount of proceeds due the husband is $\frac{\$30,000}{\$40,000} \times \$60,000$ or $45,000. Since he received only $35,000, he made a gift of $10,000. It should be noted that this section of the 1954 Code applies only to real property held by husband and wife and not to personal property or bank accounts so held. It also applies to real property held jointly with right of survivorship and other tenancies of real property having the same effect as a tenancy by the entireties.

Under present law, transfers between spouses under property settlements incident to a divorce are subject to substantial uncertainty as to whether they are subject to gift tax. The 1954 Code resolves this problem by providing that transfers of property between husband and wife pursuant to a written agreement relative to their marital and property rights or to provide a reasonable allowance for the support of issue of the spouses during minority, will be exempt from gift tax provided that divorce occurs within two years after entering the agreement.

Deductions. As in the case of the estate tax, the 1954 Code permits a

legal life estate accompanied by a power of appointment as to the principal, to qualify for the gift tax marital deduction in the case of a gift by one spouse to the other. The necessity of the intervention of a trust is eliminated as in the new estate tax marital deduction. It is also possible under the 1954 Code for a part of transferred property to qualify for the marital deduction. Community property converted to separate property after December 31, 1941, is to be regarded as community property for purposes of the marital deduction as in the case of the estate tax under the new law.

Taxable Gifts. Under certain court decisions, a gift of the present right to receive income has been regarded as a future interest if powers are given to a trustee to pay the principal to the income beneficiary at the trustee's uncontrolled discretion. The $3,000 exclusion thus has not been allowed in the case of such gifts.

The new law provides that where there has been a transfer of the present interest of property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in determining whether the gift is a future interest, provided that no part of such interest will pass to any other person. Thus, a present gift of income with an uncontrolled right in the trustee to pay principal to the income beneficiary, qualifies for the $3,000 exclusion.

Another provision of the new law provides that a gift of income to a person under twenty-one years of age shall not be considered a future interest if the income may be accumulated to the time he reaches the age of twenty-one and the principal will be payable to him or as he may appoint at such time, or to his estate if he dies prior to that time.

In computing the gift tax, gifts for prior years are considered in determining the amount of taxable gifts. Under the new Code, the *value* of gifts for a prior year cannot be adjusted in computing the tax where tax was paid and the statute of limitations has run with respect to the prior year. However, if no tax was paid, the value may be adjusted, or if there is an issue other than valuation, adjustment may be made in the prior years' taxable gifts.

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